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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1945

No. 56

KIRBY PETROLEUM COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 9, 1945.

CERTIORARI GRANTED MAY 21, 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

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—9441

[fol. a] [Caption omitted]

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IN THE TAX COURT OF THE UNITED STATES

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appearances:

For Taxpayer: H. P. Haschke, C. P. A., Homer L. Bruce, Esq.

For Comm'r: L. E. Keir, Esq.

DOCKET ENTRIES

1943

May 3. Petition received and filed. Taxpayer notified Fee paid.

May 4. Copy of petition served on General Counsel.

Jun. 4. Answer filed by General Counsel.

Jun. 4. Request for hearing in Houston, Texas, filed by General Counsel.

Jun. 8. Notice issued placing proceeding on Houston, Texas calendar. Answer and request served.

Sep. 16. Hearing set October 25, 1943—Galveston, Texas.

Oct. 26. Hearing had before Judge Black, on the merits. Submitted. Stipulation of facts and exhibits attached thereto filed. Briefs due 1-2-44. No replies.

Nov. 16. Notice of appearance of Homer L. Bruce filed by taxpayer.

Nov. 30. Transcript of hearing 10-26-43 filed.

Dec. 13. Brief filed by taxpayer.

[fol. 3] Dec. 30. Opinion rendered—Judge Black, Div. 15. Decision will be entered under Rule 50. 12-30-43. Copy served.

Dec. 31. Brief filed by General Counsel. Served 1-3-44.

1944.

Jan. 3. Copy of brief served on General Counsel.

Feb. 1. Computation of deficiency filed by General Counsel.

Feb. 3. Consent to settlement filed by taxpayer.
Feb. 5. Decision entered. Eugene Black, Judge. Div. 15.
Apr. 21. Petition for review by U. S. Circuit Court of Appeals, 5th Circuit, with assignments of error filed by General Counsel.
May 2. Proof of service filed by General Counsel. (2)
Jun. 9. Praecipe for record filed by General Counsel.

[fol. 4] THE TAX COURT OF THE UNITED STATES

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION—Filed May 3, 1943

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols IRA:90D-H, dated February 5, 1943) and as a basis for this proceeding alleges as follows:

(1) That the Petitioner is a Delaware corporation with its principal office in the City of Houston, State of Texas.

(2) The notice of deficiency (a copy of which is attached hereto and marked Exhibit A) purports to have been mailed to Petitioner under date of February 5, 1943.

(3) The taxes in controversy are income taxes of the Petitioner for the taxable year ended December 31, 1940 in the amount of $2,120.44.

(4) In the determination of income tax set forth in said deficiency notice, the Commissioner committed the following error:

(A) In disallowing as a deduction in the taxable year ended December 31, 1940 the sum of $7,211.52 representing statutory 27½% depletion claimed by Petitioner on the amount received by it ($26,223.70) as its share of the net

profits from operations by the lessee, Humble Oil & Refin-
[fol. 5] ing Company, of the Anna Higgins Tract #40 in Chambers County, Texas.

(5) The facts upon which petitioner relies as a basis in this proceeding are as follows:

(A)(1) On December 6, 1923, petitioner acquired fee simple title to the tract of land in Chambers County, Texas, known as Anna Higgins Tract #40. This tract was acquired by deed from Old River Company to petitioner and contained 49.5 acres, described by metes and bounds in the deed as recorded in the Deed Records of Chambers County, Texas. However, one-eighth of the mineral interest in said tract of land was owned by Anna Higgins, wife of Patillo Higgins, former fee owner, and was never acquired by petitioner.

(A)(2) On September 29, 1927, petitioner executed an oil and gas lease to Humble Oil & Refining Company and Marland Oil Co. of Texas whereby the Anna Higgins Tract #40, together with another tract of land out of the Jergins Survey in Chambers County, Texas, was leased for a primary term of five years. (The tract of land out of the Jergins Survey is not involved in this petition as no production has been obtained therefrom under this lease although it is validated by the production of oil from the Anna Higgins Tract #40.)

(A)(3) As consideration for the execution of such lease, petitioner received a cash bonus of $35,000.00 and an additional bonus measured by and consisting of twenty per cent (20%) of the net money profits derived by lessees from operations under and by virtue of said lease.

(A)(4) This additional bonus to be received by petitioner was provided for and specifically described and defined by a supplemental agreement entered into by petitioner and lessees simultaneously with the execution of the lease instrument on September 29, 1927. This supplemental agreement is made a part of such lease by specific reference thereto in the supplemental agreement and such agreement states that the parties to said lease have
[fol. 6] agreed that petitioner shall be entitled to receive twenty per cent (20%) of the net money profits derived by lessees from operations under said lease. This supplemental agreement describes and defines the calculation

and determination and the method of payment of such share of the profits to petitioner.

(A) (5) By the terms of such lease, lessee is to pay a one-sixth royalty on oil and gas produced and saved from said land, the same to be delivered at the wells or to the credit of lessor in the pipe line to which the wells may be connected.

(A) (6) Petitioner therefore reserved a one-sixth oil and gas royalty by such lease. However, after deducting therefrom the one-eighth royalty payable to Anna Higgins, which mineral interest petitioner never acquired, petitioner retained a net one-twenty-fourth oil and gas royalty interest in such tract of land under and by virtue of said lease. Since petitioner is the original lessor, it therefore retained an economic interest in the oil and gas in place under the Anna Higgins Tract #40.

(A) (7) Lessee commenced the drilling of a well on the Anna Higgins Tract #40 in August 1932 prior to the termination of the primary term of the lease and obtained production of oil therefrom. By December 1934 lessee had recovered its cost of development from proceeds of the sale of oil and in March 1935, petitioner received the first payment of its profits from the operation of the lease as provided in the supplemental agreement. Petitioner has received such payments of profits each year from 1935 through 1940 and for the year 1940, the amount of such profits payments received was $26,223.70.

(A) (8) Under the terms of the lease and supplemental agreement, the profits payments represent additional cash bonus paid by the lessee in consideration for the execution of the lease by the lessor. There is no difference between the payments received by petitioner as its share of lessee's [fol. 7] profits from the operations of the lease and the cash bonus received in 1927. The provision in said supplemental agreement that the payment was to be a percentage of the lessee's income from operations of the lease, represents simply a method or means of determining the amount of the bonus to be received by petitioner.

(A)(9) Lessee, Humble Oil & Refining Company, is required by the Commissioner of Internal Revenue to capitalize for income tax purposes, the profits payments made

to petitioner as a cost of the lease, thus indicating that these payments constitute a bonus paid to the lessor by the lessee as consideration for the execution of the lease.

(A)(10) Respondent has allowed for 1940 depletion on the one-twenty-fourth oil and gas royalty interest payments received by petitioner in that year.

(A) (11) Under the provisions of Regulations 103, Section 19.23(m)-10(d), the owner of an economic interest in oil and gas wells may take as a depletion deduction, in respect of any bonus or advanced royalty from the property for the taxable year, 27½% of the amount thereof.

(A)(12) Petitioner therefore is entitled to deduct in 1940, allowable statutory depletion of 27½% ($7,211.52) on the profits payments received in 1940, amounting to $26,223.70, as these payments constitute bonus received for the execution of a lease, by which lease taxpayer, being the fee owner, retained a net one-twenty-fourth royalty inteerst -n the land leased which constitutes an economic interest in the oil and gas under the tract of land leased.

Wherefore, the petitioner prays that this Court may hear and determine its appeal;

Petitioner further prays that the Court may determine that:

(1) Petitioner owes no income tax for the year 1940 in excess of $930.55.

[fol. 8] (2) That the Court may grant such other and further relief as the nature of the case may warrant.

Kirby Petroleum Company, by (Sgd.) George Sawtelle, President (Petitioner).

Dated: Houston, Texas, April 30, 1943.

(Sgd.) H. P. Haschke, Counsel, % Peat, Marwick, Mitchell & Co., 703 National Bank Bldg., Houston, Texas.

Duly sworn to by George Sawtelle. Jurat omitted in printing.

[fol. 9] EXHIBIT "A" TO PETITION

Treasury Department

Internal Revenue Service

Dallas, Tex.

Dallas
IRA :90D-H.

Kirby Petroleum Company, 1121 Commerce Building, Houston, Texas

SIRS:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1940 discloses a deficiency of $2,120.44, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 422 Federal Building, Dallas, Texas, for the attention of C:RLP. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest [fol. 10] period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner; by (Sgd.) B. W. Wilde, Internal Revenue Agent in Charge.

Enclosures: Statement Form of waiver.

Copy

STATEMENT

Dallas
IRA :90D-H.

Kirby Petroleum Company,
1121 Commerce Building,
Houston, Texas

Tax Liability for the Taxable Year Ended December 31, 1940

	Liability	Assessed	Deficiency
Income Tax	$2,120.44	$ None	$2,120.44

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated April 1, 1942; to your protest executed June 5, 1942; and to the statements made at the conferences held on July 6, 1942 and November 24, 1942.

If you do not acquiesce in all of the adjustments making up the deficiency indicated, but desire to stop the accumula- [fol. 11] tion of interest on that part of the deficiency resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of the deficiency you desire to have assessed at once. The execution of the form for the agreed portion of the deficiency will not deprive you of your right to petition The Tax Court of the United States for a redetermination of the deficiency.

Copies of this letter and statement have been mailed to your representatives, Mr. H. P. Haschke, State National Bank Building, Houston, Texas, and Mr. Frank C. Taylor, 220 Construction Building, Dallas, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

Adjustments to Net Income

Net income as disclosed by return (Loss)		($9,208.31)
Unallowable deductions and additional income:		
(a) Depreciation	$4,659.13	
(b) Depletion	8,094.67	
(c) Loss on property exchanged	46.88	
(d) Capital stock tax	230.35	
(e) Abandoned equipment	9,528.41	22,559.44
Net income adjusted		$13,351.13

Explanation of Adjustments

(a) This item represents excessive depreciation deducted on transportation equipment, furniture and fixtures, and well equipment, as shown below:

Depreciation	Deducted	Allowed	Decease
Furniture and Fixtures	$515.20	$185.92	$329.28
Transportation equipment	1,387.09	1,360.96	26.13
Lease and well equipment	30,456.53	26,152.81	4,303.72
Totals	$32,358.82	$27,699.69	$4,659.13

[fol. 12]

Determined allowable	27,599.69
Disallowed	$4,659.13

(b) This item represents depletion adjustment as follows:

	Depletion	
	Reported	Corrected
Operating Leaseholds	$88,162.96	$87,381.14
Producing royalties	38,821.89	31,509.04
	$126,984.85	$118,890.18
	118,890.18	
Total adjustment	$8,094.67	

It is held that no depletion is allowable in respect to the amount $26,223.70 received by you as your share of your lessee's net profits from operations.

(c) This item is represented by loss claimed on exchange of two typewriters for new typewriters in taxable year. Such apparent losses are not deductible but should be added to the bases of the new machines.

(d) This item represents excessive deduction for Federal capital stock tax as shown below.

Capital stock tax as deducted	$3,530.35
Capital stock tax allowable	3,300.00
Adjustment	$230.35

You have been allowed capital stock tax as accrued inasmuch as your records are kept on the accrual basis.

(e) It is held that no loss was sustained upon retirement of well equipment on the Carrie Baker lease.

[fol. 13] Computation of Tax

Income Tax

Net income	$13,351.13
Adjusted net income	$13,351.13
Amount subject to income tax	$13,351.13
13.5% of $5,000.00 (Not in excess of $5,000)	$675.00
15% of $8,351.13 (Over $5,000 to $13,351.13)	1,252.67
Total	$1,927.67
Defense tax (10% of $1,927.67)	192.77
Correct income tax liability	$2,120.44
Income tax assessed, account #852143	None
Deficiency of income tax	$2,120.44

[fol. 14] THE TAX COURT OF THE UNITED STATES

[Title omitted]

ANSWER—Filed June 4, 1943

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

(1)-(3). Admits the allegations contained in paragraphs (1) to (3), inclusive, of the petition.

(4) (A). Denies that the Commissioner erred as alleged in subparagraph (A) of paragraph (4) of the petition.

(5) (A) (1)-(9). Denies the allegations set forth in subparagraphs (A) (1) to (A) (9), inclusive, of paragraph (5) of the petition.

(A) (10). Admits that the Commissioner allowed for 1940 depletion on the one-twenty-fourth oil and gas royalty interest payments received by petitioner in that year, as alleged in subparagraph (A) (10) of paragraph (5) of the petition.

(A) (11)-(12). Denies the allegations contained in subparagraphs (A) (11) and (A) (12) of paragraph (5) of the petition.

[fol. 15] Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

(Signed) J. P. Wenchel FBS.

J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, Division Counsel; Loyal E. Keir, Special Attorney, Bureau of Internal Revenue.

LEK:MJH.

[fol. 16] The Tax Court of the United States

Docket No. 150

Kirby Petroleum Company, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

Promulgated December 30, 1943

Petitioner was the fee simple owner of two tracts of land and leased them to oil companies for exploration

and production. In the lease petitioner reserved to itself a one-sixth oil royalty and in a contemporaneous written agreement entered into between petitioner and the lessees it was agreed that in addition to the one-sixth oil royalty petitioner should be entitled to receive twenty percent of the net profits realized by the lessees from their operations of the lease. The Commissioner has allowed petitioner percentage depletion of its one-sixth oil royalty received but has disallowed depletion on the amount paid petitioner as twenty percent net profits from the operation of the lease. *Held*, petitioner is entitled to percentage depletion on the twenty percent profits paid it by reason of its reserved interest in the oil in place. *W. S. Green*, 26 B.T.A. 1017 and *Marrs McLean*, 41 B. T. A. 565, follow. *Helvering v. Elbe Oil Development Co.* 303 U. S. 372, distinguished.

Homer L. Bruce, Esq., for the petitioner.

Loyal E. Keir, Esq., for the respondent.

Opinion

Black, Judge:

The Commissioner has determined a deficiency in petitioner's income tax for the year 1940 of $2,120.44.

The deficiency results from five adjustments to net income as disclosed by petitioner in its return for the year 1940. The only one of these adjustments which petitioner contests is adjustment (a). Petitioner concedes the correctness of the other four adjustments made by the Commissioner and [fol. 17] states in its brief that it has paid the additional tax due to these items. As to adjustment (a) the petitioner alleges that the Commissioner erred:

> In disallowing as a deduction in the taxable year ended December 31, 1940 the sum of $7,211.52 representing statutory 27½% depletion claimed by Petitioner on the amount received by it ($26,223.70) as its share of the net profits from operations by the lessee, Humble Oil & Refining Company, of the Anna Higgins Tract #40 in Chambers County, Texas.

The facts have been stipulated and as stipulated are adopted as our findings of fact. Only a brief resume of these facts is necessary to an understanding of the issue which we have to decide.

Petitioner is a Delaware corporation with its principal office in Houston, Texas.

The income tax return of petitioner for the taxable year 1940 was filed with the Collector of Internal Revenue for the First District of Texas at Austin, Texas.

Prior to September 27, 1927, petitioner was the owner of the fee simple title to two tracts of land situated in Chambers County, Texas, aggregating slightly more than 100 acres, except as to one of the tracts Anna Higgins owned 1/8 of the mineral interest in said tract and that interest was never acquired by petitioner.

On September 29, 1927, petitioner leased the two tracts of land in question to Humble Oil & Refining Company, sometimes hereafter referred to as Humble, and Marland Oil Company of Texas, sometimes hereafter referred to as Marland, for oil and gas exploration and production. Petitioner in said lease retained a royalty of 1/6 of all oil produced and saved and varying royalties on other mineral.

Contemporaneously with the execution and delivery of the lease, petitioner and the lessees executed an agreement under which petitioner was entitled to receive 20 percent [fol. 18] of the net profits realized by the lessees from their operations under and by virtue of the lease. The agreement in that respect reads as follows:

> Second Party, [meaning Kirby Petroleum Company] subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty percent (20%) of the net money profits realized by First Party from its operations under and by virtue of the lease referred to above. The net money profits in which Second Party shall participate under the terms hereof, shall be calculated and determined and be payable as hereinafter provided.

Section III and V of the agreement provide how the net profits from the operation of the lease shall be calculated and how petitioner's share of such net profits shall be paid over to it. These provisions need not be set out here as there is no controversy about them.

The lessees drilled and completed the first well in 1932 and have produced oil from the lease continuously thereafter. In 1935 petitioner received its first payment under the profits agreement from the operation of the leased premises and received such payment for each year from

1935 through 1940. The amount received under the profits agreement for 1940 was $26,223.70. In its return for 1940 petitioner deducted for depletion 27½ percent of this amount. The question which we have to decide is whether petitioner is entitled under the applicable statute to the percentage depletion which it has thus deducted. The applicable statute is section 114 (b) (3), I. R. C., which is printed in the margin.[1]

[fol. 19] Petitioner in support of its contention relies principally upon our decision in *W. S. Green*, 26 B. T. A. 1017. In that case we held that the taxpayer, a lessor of oil property, was entitled to depletion on sums received on his one-third interest in the profits from the lessee's operations in addition to depletion on his 3/32 royalty interest. There can be no doubt that our decision in the *Green* case is in point to a decision of the issue in the instant case and should be followed unless decisions by the Supreme Court of the United States have in effect overruled it. The Commissioner contends that such is the case and cite in support of his contention *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372; *Anderson v. Helvering*, 310 U. S. 404.

Petitioner contends that these cases are clearly distinguishable on their facts from the instant case. Petitioner points out that in the *O'Donnell* case the taxpayer owned part of the stock of San Gabriel Petroleum Company, which he sold to the Petroleum Midway Company, Ltd. As consideration for the payment of this stock the Midway Company agreed to acquire the properties of the San Gabriel Company and to pay the taxpayer ⅓ of the net profits from the operation of those properties. The petitioner points out that through this arrangement the taxpayer ac-

[1] (3) Percentage depletion for oil and gas wells. In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

quired no interest in the oil and gas in place, and inasmuch as he owned none before hand the Supreme Court properly denied any depletion on the payments made to him out of the profits derived by the Midway Company from the operation of the San Gabriel oil and gas properties.

In distinguishing *Helvering v. Elbe Oil Land Development Co., supra,* the petitioner points out that the taxpayer in that case sold absolutely all of its interest in certain oil and gas properties for $350,000 in cash, $1,650,000 additional cash payable over a period of four years and for the additional agreement by the purchaser to pay the taxpayer one-third of the net profits resulting from the operation of the properties after the purchaser had re-[fol. 20] covered all of its expenditures in the acquisition, development and operation of the properties. The agreement specifically provided that it was the intention of the parties that the full ownership, possession, and control of the properties should be vested in the purchaser and that the taxpayer should have no interest whatsoever in the properties. Petitioner points out that the Supreme Court under such circumstances properly denied to Elbe Oil Land Development Company depletion on the payments received under the contract because the payments were simply payments to the taxpayer of a part of the purchase price of property which it had sold and that the taxpayer was entitled to no percentage depletion on these payments because it had retained no capital investment in the properties. Petitioner distinguishes *Anderson v. Helvering, supra,* on like grounds.

In the instant case petitioner lays emphasis on the fact that it was the owner in fee simple of two tracts of land and leased them to Humble and to Marland for development and operation and that in granting the lease it retained for itself a 1/6 oil royalty and 20 percent net profits from the operation of the lease each year. Respondent has not disputed petitioner's right to percentage depletion on the 1/6 oil royalty reserved in the lease but does dispute petitioner's right to percentage depletion on the $26,223.70 net profits which petitioner received in 1940 from operations.

Petitioner contends that it is as much entitled to depletion on this $26,223.70 as it is on the receipts from its 1/6 oil royalty and distinguishes its situation from that which existed in *Helvering v. O'Donnell, supra,* and *Helvering v. Elbe Oil Land Development Co., supra,* and *Anderson v.*

Helvering, supra, on the grounds which we have already stated. We agree with petitioner in the distinction which it draws.

Although petitioner does not cite in its brief our decision in *Marrs McLean,* 41 B. T. A. 565, affd. on another ground 120 Fed. (2d) 942, we think our decision in that case concerning the Gray lease, issue No. 2, supports petitioner's [fol. 21] contention here. In speaking of the Gray lease in our opinion in the *McLean* case, we said:

> * * * It purported to convey only three-fourths of McLean's interest and provided: "While this contract covers only an undivided three-fourths (¾) interest in the two assigned tracts, the Gulf Refining Company of Louisiana shall, as and while it holds hereunder, have exclusive operating rights in such two assigned tracts and exclusive control and management of operation."

After stating these facts we said:

> * * * Thus, McLean retained an economic interest in a part of the oil in place and the payments which he was to receive were secured by that interest and were not dependent alone upon the contractual obligation of Gulf. Although the payments were measured by one-fourth of the net profits realized from the operation of the properties, and although there is no statement in the contract that those payments are to be made from any portion of the oil, nevertheless, this contract did not effect a sale of McLean's interest. It is unlike the contracts in the *Elba* and *Blankenship* cases, which purported to convey all of the interest of the assignors. It is more like the contracts in the *Palmer, Perkins,* and *Harmel* cases. Consequently, we hold that the petitioners are entitled to depletion in connection with the Gray leases.

What is petitioner's "gross income from the property" in 1940 within the meaning of section 114(b) (3) and which it must include in its gross income for income tax purposes? We think it is clearly the proceeds from the ⅛ royalty which petitioner retained in the lease and the 20 percent annual profits which it received from the operation of the lease under the contemporaneous agreement amounting in 1940 to $26,223.70. If this view is correct, then petitioner

is entitled to percentage depletion on the amounts received from its part of the profits as much as from the amounts [fol. 22] received from its retained 1/8 oil royalty. And in filing their returns the lessees, Humble and Marland, would not include in their gross income from the property for the purpose of taking percentage depletion, the 1/8 oil royalty plus $26,223.70 profits paid petitioner in 1940. That is the substance of what we held as to the Gray lease in the *McLean* case. On that point we said:

> * * * The term "gross income from the property" means the gross income from the property received by the particular taxpayer claiming a deduction for depletion and is synonymous with the amount to be included in the taxpayer's gross income under section 22. *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312. The gross income from the property, from the standpoint of the McLeans, was the amount which Gulf paid them. They do not even suggest the propriety of including any greater amount in their gross income under section 22. No doubt the amount which Gulf paid them would be considered a rent or royalty paid by that taxpayer in respect of the property in computing its deduction under section 114(b)(3). * * *

For the reasons stated and discussed above we sustain petitioner on the only issue submitted to us for decision.

Decision will be entered under Rule 50.

[fol. 23] THE TAX COURT OF THE UNITED STATES, WASHINGTON.

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION

Pursuant to the Court's opinion, promulgated December 30, 1943, the respondent having filed a recomputation

of tax on February 1, 1944, and the petitioner having filed an acquiescence in said recomputation on February 3, 1944, it is

Ordered and Decided: That there is a deficiency in income tax of $930.53 for the calendar year 1940.

Enter:

(Signed) Eugene Black, Judge.

Entered Feb. 5, 1944.

[fol. 24] In United States Circuit Court of Appeals for the Fifth Circuit

[Title omitted]

Petition for Review and Assignments of Error—Filed April 21, 1944

To the Honorable Judges of the United States Circuit Court of Appeals for the Fifth Circuit:

Now Comes Joseph D. Nunan, Jr., Commissioner of Internal Revenue, by and through his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and Bernard D. Daniels, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I

That he is the duly appointed, qualified and acting Commissioner of Internal Revenue, appointed and holding office by virtue of the laws of the United States; that the respondent on review, Kirby Petroleum Company (hereinafter referred to as the taxpayer) is a corporation organized and existing under the laws of the State of Delaware and having its principal office in Houston, Texas. The taxpayer filed its Federal income, excess profits and defense tax return for the calendar year 1940, the taxable year here involved, with the Collector of Internal Revenue for the [fol. 25] First Texas District, which office is located in the City of Austin, Texas, and within the judicial Circuit of the United States Circuit Court of Appeals for the Fifth Circuit.

The Commissioner filed this petition pursuant to the provisions of Section 1141 and 1142 of the Internal Revenue Code.

II

Prior Proceedings

On February 5, 1943 the Commissioner of Internal Revenue determined that there is a deficiency in income tax against the taxpayer for the year 1940 in the sum of $2,-120.44, and sent to the taxpayer, by registered mail, a notice of said deficiency in accordance with the provisions of the existing Internal Revenue Laws. Thereafter, and on May 3, 1943, the taxpayer filed an appeal from the said determination of the Commissioner with The Tax Court of the United States.

The case was duly tried and submitted to The Tax Court of the United States and on December 30, 1943, The Tax Court of the United States promulgated its opinion (2 T. C. 1258), pursuant to which opinion, decision was entered on February 5, 1944, wherein and whereby it was ordered and decided "that there is a deficiency in income tax of $930.53 for the calendar year 1940."

III

Nature of Controversy

Prior to September 27, 1927 the taxpayer was the owner of fee simple title to two tracts of land except, as to one of the tracts, Anna Higgins owned one-eighth of the mineral interests therein. On September 29, 1927 the taxpayer leased said two tracts of land to Humble Oil and Refining Company and Marland Oil Company of Texas for oil and gas exploration and production. In the said lease the taxpayer reserved to itself a one-sixth oil royalty. In a contemporaneous written agreement entered into between [fol. 26] the taxpayer and the lessees it was agreed that in addition to the one-sixth oil royalties the taxpayer should also be entitled to receive 20 percent of the net profits realized by the lessees from their operation of the lease.

During the calendar year 1940, the taxpayer received from the lessees its one-sixth royalty payment, pursuant to the terms of the lease and $26,223.70, representing 20 per cent of the net profits realized by the lessees from their operation of the lease, pursuant to the contemporaneous

written agreement between the taxpayer and the lessees. In computing its net taxable income for the year 1940, the taxpayer deducted for depletion 27½ percent of the royalty payments received and also 27½ percent of the $26,223.70.

In his determination of the deficiency due for the year 1940, the Commissioner disallowed several deductions claimed by the taxpayer on its return filed for that year. Included in the deductions disallowed by the Commissioner was an item of $7,211.52 representing statutory 27½ percent depletion claimed by the taxpayer on the amount received by it ($26,223.70) as its share of the net profits from operation of the lease by the lessees. The taxpayer, in its petition filed with The Tax Court of the United States, alleges that the Commissioner erred in disallowing as a deduction the item of $7,211.52 (statutory 27½ percent depletion on $26,223.70), but did not contest the other adjustments made by the Commissioner in his determination of the deficiency for the year 1940. The Tax Court decided that the taxpayer is entitled to the deduction for depletion in the amount of $7,211.52.

IV

Assignments of Error

The Commissioner avers that in the record and proceedings before The Tax Court of the United States and in the opinion and final decision rendered and entered by The Tax Court of the United States, manifest error occurred [fol. 27] and intervened to the prejudice of the Commissioner who now assigns the following errors and each of them, which he avers occurred in said record, proceedings, opinion, and final decision so rendered and entered by The Tax Court of the United States.

The Tax Court of the United States erred:

(1) In holding and deciding that the taxpayer was entitled to a deduction for percentage depletion in the year year 1940 in the amount of $7,211.52.

(2) In failing to hold and decide that the taxpayer was not entitled to a deduction for percentage depletion in the year 1940 in the amount of $7,211.52.

(3) In holding and deciding in effect, that the amount of $26,223.70 received by the taxpayer in the year 1940 was paid to it by reason of its reserved interest in oil in place.

(4) In failing to hold and decide that the amount of $26,223.70 received by the taxpayer in the year 1940, was not paid to it by reason of its reserved interest in oil in place.

(5) In holding and deciding that the amount of $26,223.70 received by the taxpayer in the year 1940 represented proceeds from an economic or depletable interest in oil in place.

(6) In failing to hold and decide that the amount of $26,223.70 received by the taxpayer in the year 1940 did not represent the proceeds from an economic or depletable interest in oil in place.

(7) In ordering and decided that there is a deficiency in income tax of $930.53 for the calendar year 1940.

(8) In failing to hold and decide that there is a deficiency in income tax of $2,120.44 for the calendar year 1940.

(9) In that its decision is contrary to law and regulations and is not supported by substantial evidence.

[fol. 28] Wherefore, the Commissioner petitions that the decision of The Tax Court of the United States be reviewed by the United States Circuit Court of Appeals for the Fifth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

(Sgd.) Samuel O. Clark, Jr. CAR.

(Sgd.) Samuel O. Clark, Jr., CAR., Assistant Attorney General; (Signed) J. P. Wenchel, CAR., Chief Counsel, Bureau of Internal Revenue, Of Counsel; Bernard D. Daniels, Special Attorney, Bureau of Internal Revenue.

[fol. 29] *Duly sworn to by Bernard D. Daniels. Jurat omitted in printing.*

[fol. 30] IN UNITED STATES CIRCUIT COURT OF APPEALS

[Title omitted]

NOTICE OF FILING PETITION FOR REVIEW—Filed May 2, 1944

To: Kirby Petroleum Company, Houston, Texas.

You are hereby notified that the Commissioner of Internal Revenue did, on the twenty-first day of April, 1944, filed with the Clerk of Tax Court of the United States at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fifth Circuit, of the decision of The Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the petition for review, as filed, is hereto attached and served upon you.

Dated this twenty-first day of April, 1944.

(Signed) J. P. Wenchel, CAR., Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 25th day of April 1944.

Kirby Petroleum Company, By (Sgd.) George Sawtelle (Title) President, Respondent on Review.

[fol. 31] IN UNITED STATES CIRCUIT COURT OF APPEALS

[Title omitted]

NOTICE OF FILING PETITION FOR REVIEW—Filed May 2, 1944

To: Homer L. Bruce, Esquire, 16th Floor, Niels Esperson Building, Houston, Texas:

You are hereby notified that the Commissioner of Internal Revenue did, on the twenty-first day of April 1944, file with the Clerk of The Tax Court of the United States at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fifth Circuit, of the decision of The Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the

petition for review, as filed is hereto attached and served upon you.

Dated this twenty-first day of April, 1944.

(Signed) J. P. Wenchel, CAR., Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 25th day of April, 1944.

(Sgd.) Homer L. Bruce, Attorney for Respondent on Review.

[fol. 32] Filed at Hearing.
Div. 15.

THE TAX COURT OF THE UNITED STATES

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

STIPULATION OF FACTS

The parties to the above numbered and entitled cause agree to the facts set out hereinbelow, subject to the right of either party to object to the materiality or relevancy of any of said facts, and no evidence to controvert any of said facts may be admitted in said cause.

1

Petitioner as lessor and Humble Oil & Refining Company and Marland Oil Company of Texas, as lessees, executed an oil, gas and mineral lease dated September 29, 1927, and attached hereto as Exhibit A is a true and correct copy of said lease. The lease was acknowledged by the officers of the respective parties upon the dates shown in the acknowledgments of said lease and the triplicate original executed copies thereof were delivered to the respective parties shortly after the last acknowledgment.

2

Said parties contemporaneously with the execution and delivery of said lease also executed and delivered an agreement dated September 29, 1927, and attached hereto as Exhibit B is a true and correct copy of said agreement.

[fol. 33] 3

Prior to the execution of said lease and agreement the petitioner had acquired the fee simple title to the two tracts of land described in said lease, except that as to the tract described therein as "First Tract", one Anna Higgins owned ⅛ of the mineral interest in said tract and this mineral interest was never acquired by petitioner.

4

The lessees commenced the drilling of a well on said First Tract in August, 1932, prior to the termination of the primary term of the lease, and obtained production of oil therefrom and have produced oil therefrom continuously. In March, 1935, petitioner received the first payment of its profits from the operation of said leased premises as provided in the agreement designated as Exhibit B hereto. Petitioner received such payments of profits each year from 1935 and through 1940, and for the year 1940 the amount of such profits received by petitioner was $26,223.70.

5

In its return for the year 1940 petitioner deducted as an allowance for depletion 27½% of said amount of $26,223.70, or depletion to the extent of $7,211.52. The Commissioner in his letter of deficiency disallowed this depletion deduction of $7,211.52. Petitioner does not contset any of the other changes in its income made by the Commissioner in his said deficiency letter.

6

George Sawtelle, if sworn, would testify that as Vice-President of petitioner he executed said lease and agreement set forth as Exhibits A and B and that petitioner would not have executed said lease designated as Exhibit

A unless the lessees had also executed said contemporaneous agreement designated as Exhibit B as a part of the consideration for petitioner's executing said lease, and [fol. 34] the lessees did execute said Exhibit B agreement as part of the consideration for petitioner's executing said lease, and that petitioner also received upon the execution of said lease a cash bonus from the lessees for executing said lease. Said Sawtelle shall be considered as having been sworn in this cause and as having testified as set forth in the foregoing sentence.

7

The return of petitioner for the taxable year 1940 was filed with the Collector of Internal Revenue for the First District of Texas at Austin, Texas.

Homer L. Bruce, Counsel for Petitioner.

(Signed) J. P. Wenchel. J.L.B.

J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent.

[fol. 35] Exhibit "A" to Stipulation

Oil, Gas and Mineral Lease

This Agreement made this 29th day of September, 1927, between Kirby Petroleum Company, a corporation duly incorporated under the laws of the State of Delaware with its domicile in Harris County, Texas, lessor (whether one or more), and Humble Oil & Refg. Co. and Marland Oil Co. of Texas, lessee. Witnesseth:

1. Lessor in consideration of Ten—and other valuable considerations, Dollars ($10.00) in hand paid, of the royalties herein provided and of the agreements of lessee herein contained, hereby grants, leases and lets exclusively unto lessee for the purpose of investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals, laying pipe lines, building tanks, power stations, telephone lines and other structures thereon to produce, save, take care of, treat, transport and own said products, and housing its employees the following described land in Chambers County, Texas, to wit:

First Tract: Situated in Chambers County, Texas, and a part of the Henry Griffith League, containing 49.5 acres and described by metes and bounds in a deed dated December 6th, 1923, from Old River Company to Kirby Petroleum Company and designated in said deed as "40th tract."

Second Tract: All of the Dan Jergins Survey No. 13, situated in Chambers County, Texas, and containing 52 acres of land, more or less, and described in a deed from Oil River Company to Kirby Petroleum Company, dated December 6th, 1923, and designated as "24th Tract" in said deed.

2. Subject to the other provisions herein contained, this lease shall be for a term of five years from this date (called "primary term") and as long thereafter as oil, gas or other mineral is produced from said land hereunder.

[36] 3. The royalties to be paid by lessee, are:

(a) on oil, one sixth of that produced and saved from said land, the same to be delivered at the wells or to the credit of lessor in the pipe line to which the wells may be connected; lessee may from time to time purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase; (b) on gas, including casinghead gas and other vaporous or gaseous substances, produced from said land, as follows: In case lessee shall itself use gas in the manufacture of gasoline or other products therefrom 1/6 of 25% of the market value at the plant of the gasoline or other product manufactured therefrom, quantity of product to be ascertained in a manner recognized in the industry; in case lessee shall sell gas at the wells, 1/6 of the amount realized from such sales; and in all other cases when sold or used off the premises, the market price at the well of 1/6 of the gas so sold or used; and (c) on all other mineral mined and marketed, one-sixth either in kind or value at the well or mine at lessee's election, except that on sulphur the royalty shall be fifty cents (50c) per long ton.

4. If operations for drilling are not commenced on said land on or before one year from this date this lease shall then terminate as to both parties unless on or before said anniversary date lessee shall pay or tender to lessor or to the credit of lessor in First National Bank at Hous-

ton, Texas, (which bank and its successors are lessor's agent and shall continue as the depository for all rentals payable hereunder regardless of changes in ownership of said land or the rentals) the sum of Twenty-Five Dollars per acre as above designated, (herein called rental), which shall cover the privilege of deferring commencement of drilling operations for a period of twelve (12) months. In like manner and upon like payments or tenders annually the commencement of drilling operations may be further deferred for successive periods of twelve (12) months each during the primary term. The payment or tender of rentals may be made by the check or draft of lessee mailed or delivered to said bank on or before such [fol. 37] date of payment. If such bank (or any successor bank) shall fail, liquidate or be succeeded by another bank, or for any reason fail or refuse to accept rental, lessee shall not be held in default for failure to make such payment or tender of rental until thirty (30) days after lessor shall deliver to lessee a proper recordable instrument, naming another bank as agent to receive such payments or tenders. The down cash payment is consideration for this lease according to its terms and shall not be allocated as mere rental for a period.

5. If prior to discovery of oil or gas on said land lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or re-working operations within sixty days thereafter or (if it be within the primary term) commences or resumes the payment of tender of rentals on or before the rental paying date next ensuing after the expiration of three months from date of completion of dry hole or cessation of production. If at the expiration of the primary term oil or gas is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than 30 consecutive days, and if they result in the production of oil or gas, so long thereafter as oil or gas is produced from said land. In the event a well or wells producing oil or gas in paying quantities should be brought in on adjacent land and within 150 feet of and draining the leased premises, lessee agrees to drill

such offset wells as a reasonably prudent operator would drill under the same or similar circumstances.

6. Lessee shall have free use of oil, gas, wood and water from said land, except water from lessor's well, for all operations hereunder, and the royalty on oil and gas shall be computed after deducting any so used. Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by lessee on said land, including the right to draw and remove all casing. When required by lessor, lessee will [fol. 38] bury all pipe lines below ordinary plow depth, and no well shall be drilled within two hundred feet of any residence or barn now on said land without lessor's consent. Lessor shall have the privilege at his risk and expense of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon out of any surplus gas not needed for operations hereunder.

7. The rights of either party hereunder may be assigned in whole or in part and the provisions hereof shall extend to the heirs, successors and assigns, but no change or divisions in ownership of the land, rentals, or royalties however accomplished shall operate to enlarge the obligations or diminish the rights of lessee. No sale or assignment by lessor shall be binding on lessee until lessee shall be furnished with a certified copy of recorded instrument evidencing same. In event of assignment of this lease as to a segregated portion of said land the rentals payable hereunder shall be apportionable as between the several leasehold owners ratably according to the surface area of each, and default in rental payment by one shall not affect the rights of other leasehold owners hereunder. If six or more parties become entitled to royalty hereunder, lessee may withhold payment thereof unless and until furnished with a recordable instrument executed by all such parties designating an agent to receive payment for all.

8. All obligations of lessee hereunder, both express and implied, are to be understood as covenants and not conditions or limitations; and, save as hereinafter expressly provided, the breach of same shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby nor be grounds for a cancellation hereof, in whole or in part. If the obliga-

tion for reasonable development should require the drilling of a well or wells, lessee shall have 90 days after final judicial ascertainment of the existence of such obligation by the court of last resort hearing such matter within which to begin the drilling of a well, and the only penalty for failure to do so shall be the termination of this lease save as to 10 acres for each well being worked on and/or [fol. 39] being drilled and/or producing oil or gas to be selected by lessee so that each 10-acre tract will embrace one such well.

9. Lessor hereby warrants and agrees to defend the title to said land and agrees that lessee at its option may discharge any tax, mortgage or other lien upon said land and in event lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and royalties accruing hereunder toward satisfying same. Without impairment of lessee's rights under the warranty in event of failure of title, it is agreed that if lessor owns an interest in said land less than the entire fee simple estate, then the royalties and rentals to be paid lessor shall be reduced proportionately.

In Witness Whereof, this instrument is executed on the date first above written, in triplicate originals.

Kirby Petroleum Company, by George Sawtelle, Vice-President.

Attest: C. W. Craig, Secretary. (Seal.)

Humble Oil & Refining Company, by F. P. Sterling, Vice-President.

Attest: Jas. Strate, Asst. Secretary. (Seal.)

Marland Oil Company of Texas, by W. A. Moncrief, Vice-President.

Attest: Wm. Preston, Secretary. (Seal.)

[fol. 40] The State of Texas,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared George Sawtelle, Vice-President of the Kirby Petroleum Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capac-

ity therein stated and as the act and deed of Kirby Petroleum Company.

Given Under My Hand and seal of office, this the 5th day of October, A. D. 1927. Alice Newcomer, Notary Public in and for Harris County, Texas. (Seal.)

THE STATE OF TEXAS,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared F. P. Sterling, Vice-President of Humble Oil & Refining Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of said corporation.

Given Under My Hand and seal of office, this 20th day of October, A. D. 1927. James S. Clarke, Notary Public in and for Harris County, Texas. (Seal.)

[fol. 41] THE STATE OF TEXAS,
County of Tarrant:

Before Me, the undersigned authority, on this day personally appeared W. A. Moncrief, Vice-President of Marland Oil Company of Texas, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed in the capacity therein stated, and as the act and deed of said Marland Oil Company of Texas.

Given Under My Hand and seal of office, this the 17th day of October, A. D. 1927. Grace Moore, Notary Public in and for Harris County, Texas. (Seal.)

[fol. 42] EXHIBIT "B" TO STIPULATION

THE STATE OF TEXAS,
County of Harris:

This Agreement This Day Made And Entered Into between Humble Oil & Refining Company and Marland Oil

Company of Texas, hereinafter called First Party (whether one or more), and Kirby Petroleum Company, hereinafter called Second Party, all of said parties being private corporations duly authorized to do business in the State of Texas, Witnesseth:

Second Party, as lessor has this day executed and delivered to the First Party, as lessee, an oil, gas and mineral lease covering two tracts of land in Liberty and Chambers Counties, Texas, described as follows, to-wit:

> First Tract: Situated in Chambers County, Texas, and a part of the Henry Griffith League, containing 49.5 acres and describes by metes and bounds in a deed dated December 6th, 1923 from Old River Company to Kirby Petroleum Company and designated in said deed as "40th tract".
>
> Second Tract: All of the Dan Jergins Survey No. 13, situated in Chambers County, Texas, and containing 52 acres of land, more or less, and described in a deed from Old River Company to Kirby Petroleum Company dated December 6th, 1923, and designated as "24th Tract" in said deed.

The parties to said lease have agreed that Second Party shall be entitled to receive twenty percent (20%) of the net money profits derived by First Party from operations under said lease, said twenty percent (20%) net money profits interest being specifically described and *and* defined and payable as is hereinafter provided.

[fol. 43] Now, Therefore, in consideration of the premises and Ten Dollars ($10.00) in hand paid by Second Party to First Party, the receipt of which is acknowledged, and the mutual covenants and obligations of the parties hereto, it is hereby agreed as follows, to-wit:

I

Second Party, subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty percent (20%) of the net money profits realized by First Party from its operations under and by virtue of the lease referred to above. The net money profits in which Second Party shall participate under the terms hereof, shall be calculated and determined and be payable as hereinafter provided.

II

First Party shall have exclusive charge, control and supervision of all operations of every kind to be conducted on said land for the development, production, treating, handling ~~and~~ marketing of oil, gas and other minerals therefrom, as well as the payment of rentals, royalties, taxes and other charges which may arise or become due.

III.

First Party shall charge to the account covering the lease referred to above, all costs and expenses incurred in connection with the operation of said premises including all labor directly employed in connection with the operation of said property; all materials, supplies and equipment, including rentals on all trucks, drilling rigs, tools, pipes, etc., let for use in connection with the operation of said property, at the current prevailing rental charge by First Party to its own leases, said trucks, rigs and other rented property to be returned by said accounts in the same condition as when received, reasonable wear and tear excepted; miscellaneous field expenses apportionable in connection with operations on the above described property; all charges for fuel, water, power, teaming and other [fol. 44] services incurred in connection with the operation of said premises, such charges to be made only for actual services rendered and at the current customary rates prevailing in the field; losses, damages or liabilities sustained or incurred in connection with the operation of said property; expenses of marketing the products; royalties and other items payable to other than lessor under the terms of the lease covering said land; gross production, ad valorem and other taxes and governmental charges, except Federal Income Taxes; workmen's compensation, liability, fire, wind, tornado and other insurance premiums paid.

No home office, or other overhead charge shall be made to the joint account in connection with the operation of said premises, but, to cover bookkeeping, accounting and office expenses generally, a charge of Twenty-five Dollars ($25.00) per well per month shall be made to joint account, and to cover supervision and all other general and division overhead expenses, a charge of Twenty-five Dollars ($25.00) per month on each producing well and Fifty Dollars ($50.00) per month on each drilling well shall also

be made to joint account. Second-hand material and equipment supplied to the premises shall be charged to the account at their fair value, not to exceed (except as to small pipe fittings) seventy-five percent (75%) of the current market price of new materials and equipment of like kind at the time of transfer. All materials, supplies and equipment furnished from First Party's warehouse shall be charged to the account at cost to First Party, including freight, plus five percent (5%) on pipe and tubular goods and ten percent (10%) on other materials and supplies, as warehouse and handling charges. Used materials removed from the premises by First Party, whether upon abandonment or currently in course of operation, shall be credited to the account at the current prevailing discounts used by First Party upon removal of such materials from its own properties. Any material charged against the lease but not used by the *lease* and removed from the premises by First Party shall be credited to the account at its fair value.

[fol. 45] Should the title of the lessors in the lease referred to above fail in whole or in part, and First Party become obligated or required to pay damages by reason of its operations under said lease, Second Party agrees to reimburse First Party within Fifteen (15) days after demand made by First Party to the extent of Twenty percent (20%) of such damages, provided, however, Second Party shall not be required to pay First Party an amount in excess of the amounts which had theretofore been received by Second Party, but any such excess shall be charged as a loss against the returns from said tracts of land for the first and successive months until First Party has been fully indemnified. Any expenses or costs incurred by First Party in defending any suit involving the title or the rights of First Party under the lease referred to above, shall be charged to the account covering the lease as a part of the costs of operations.

IV

First Party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, and in which the parties hereto may be interested. Upon the sale of any of such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales. If it desires to

do so, First Party may take over all or any part of such production itself for its own use and benefit, and in such event, the accounts (covering the lease referred to above) shall be credited on the following basis, to-wit:

(a). On Oil: The current price per barrel on the date of respective runs to pipe line, or if not run to pipe line, then on date of respective runs to storage for account of First Party, posted by First Party for the field where the production is located.

(b). For gas of any kind: The market value at the well.

(c). Other Minerals: The market value at the well or mine.

[fol. 46] V

The total net profits (or total net loss as the case may be) shall be determined by deducting the total charges made against the lease as authorized herein from the total credits allowed the lease as authorized herein.

Second Party shall participate in the profits derived from the sale of the oil and gas and other mineral production of the lease embraced in this agreement only after all charges and debits and costs of producing profits shall have been paid and provided for. It is expressly agreed that First Party shall have the right to carry forward any loss from operations as a charge against the net profit account for the next and succeeding months until such loss has been wiped out and paid.

VI

First Party shall keep an accurate record of all accounts hereunder showing the costs and expenses incurred and charges made and all authorized credits and returns made and received, which record shall be available at all reasonable times for the examination and inspection of First Party and his or its duly authorized representatives. Second Party shall also have access at all reasonable times to the well and production records and reports relating to said premises. Within one (1) month after the close of each calendar month First Party shall furnish to Second Party a statement of authorized expenses incurred and charges made and authorized credits made during

such calendar month. Any exceptions to the statement as rendered by First Party must be made by Second Party within sixty (60) days from the receipt of same and if no exception is made within such time, then such statement shall be considered as correct.

[fol. 47] Within one (1) month after the close of each calendar month Second Party shall be paid its twenty percent (20%) of the net money profits derived from the operation of the said lease as calculated and determined under the terms hereof.

VII

In case of disagreement as to any matter relating to the correctness of the accounts hereunder which can not be settled amicably, then, upon five days' written notice given by one party to the other, such matter in disagreement shall be submitted to a board of three arbitrators. Each party hereto agrees to appoint one arbitrartor within ten (10) days after such notice is given; the third arbitrator shall be chosen promptly by the two so appointed; all three arbitrators shall be disinterested practical oil operators. Pending a decision of such board of arbitrators, the parties hereto shall remain bound by the express terms hereof. Any and all decisions rendered by a majority of said board of arbitrators shall be final and binding upon the parties hereto, and adjustments shall be made in conformity with their award.

VIII

Any written notices required or permitted to be given hereunder may be made or given to First Party as follows: To Humble Oil & Refining Company at its office in Houston, Texas, and to Marland Oil Company of Texas at its office in Fort Worth, Texas, and may be given to Second Party at Houston, Texas. The statements and payments provided for in paragraph VI hereof, may be made to Second Party at Houston, Texas.

IX

This contract shall be binding upon the parties hereto and their respective successors in interest.

[fol. 48] In Testimony Whereof, witness the hands and seals of the parties hereof, in triplicate originals, this the 29th day of September, A. D. 1927.

Humble Oil & Refining Company, by F. P. Sterling, Vice-President. (Seal.)

Attest: Jas. Strate, Asst. Secretary.

Marland Oil Company of Texas, by W. A. Moncrief, Vice-President. First Party. (Seal.)

Attest: Wm. Preston, Secretary.

Kirby Petroleum Company, by George Sawtelle, Vice-President. Second party. (Seal.)

Attest: C. W. Craig, Secretary.

[fol. 49] The State of Texas,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared F. P. Sterling, Vice-President of Humble Oil and Refining Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of said Corporation.

Given Under My Hand and seal of office, this the 20th day of October, A. D. 1927.

James S. Clark, Notary Public in and for Harris County, Texas. (Seal.)

The State of Texas,
County of Tarrant:

Before Me, the undersigned authority, on this day personally appeared W. A. Moncrief, Vice-President of Marland Oil Company of Texas, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of Marland Oil Company of Texas.

Given Under My Hand and seal of office, this the 17th day of October, A. D. 1927.

Grace Moore, Notary Public in and for Tarrant County, Texas. (Seal.)

[fol. 50] THE STATE OF TEXAS,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared George Sawtelle, Vice-President of Kirby Petroleum Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowleged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of Kirby Petroleum Company.

Given Under My Hand and seal of office, this the 5th day of October, A. D. 1927.

Alice Newcomer, Notary Public in and for Harris County, Texas. (Seal.)

Finis

[fol. 51] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

[Title omitted]

PRAECIPE FOR RECORD—Filed June 9, 1944

To the Clerk of The Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, copies duly certified as correct, of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Fifth Circuit, heretofore filed by the Commissioner of Internal Revenue:

(1) Docket entries of the proceedings before The Tax Court of the United States.

(2) Pleadings before The Tax Court of the United States:

(a) Petition filed May 3, 1943 (with Exhibit, deficiency letter, attached).

(a) Answer filed June 4, 1943.

(3) Opinion of The Tax Court of the United States reported in 2 T. C. 1258.

(4) Decision of The Tax Court of the United States entered February 5, 1944.

(5) Petition for review and assignments of error, together with proof of service of Notice of Filing Peti-[fol. 52] tion for Review and Assignments of Error.

(6) Agreed Stipulation of Facts including attached Exhibits "A" and "B."

(7) This Praecipe for Record.

The said Transcript to be prepared, certified and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Fifth Circuit.

(Sgd.) Samuel O. Clark, Jr., C. A. R., Assistant Attorney General; (Signed) J. P. Wenchel, C. A. R., Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Service of a copy of the within Praecipe for Record on review is hereby admitted this — day of June, 1944.

Agreed to:

Homer L. Bruce, Attorney, 16th Floor, Niels Esperson Building, Houston, Texas, Attorney for Respondent on Review.

[fol. 53] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 54] That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:—

ARGUMENT AND SUBMISSION

Extract from the Minutes of January 31, 1945

No. 11065

COMMISSIONER OF INTERNAL REVENUE,

versus

KIRBY PETROLEUM COMPANY

On this day this cause was called, and, after argument by I. Henry Kutz, Esq., Special Assistant to the Attorney General, for petitioner, and Homer L. Bruce, Esq., for respondent, was submitted to the Court.

[fol. 55] OPINION OF THE COURT AND DISSENTING OPINION BY HUTCHESON, CIRCUIT JUDGE—Filed March 5, 1945

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 11065

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

versus

KIRBY PETROLEUM COMPANY, Respondent

Petition for Review of Decision of the Tax Court of the United States (District of Texas)

(March 5, 1945)

Before Hutcheson, Holmes, and McCord, Circuit Judges

HOLMES, Circuit Judge:

This appeal involves income taxes of the Kirby Petroleum Company for the year 1940. The question presented for review is whether the taxpayer is entitled, under Sec-

tions 23(m) and 114(b)(3) of the Internal Revenue Code, [fol. 56] to a depletion deduction of 27½ per cent on the amount received by it as its share of the net profits realized by its lessees from operations under an oil and gas lease.

The taxpayer owned a tract of land in Texas upon which a ⅛ mineral interest had been retained by a former owner. It leased the tract to an oil company for exploration and production, reserving a 1/6 royalty in the minerals (which included the ⅛ held by the former owner) and receiving a bonus. It was stipulated that all obligations of the lessees were to be understood as covenants and not as conditions or limitations. Contemporaneously with the execution of the lease, the parties executed an agreement under which the taxpayer was to receive 20 per cent of the net profits realized by the lessees from their operations under said lease.

During the year 1940, the taxpayer received $26,223.70 as its share of the net profits. In its income tax return for that year, it deducted 27½ per cent depletion on this amount. There was no dispute as to the depletion allowances on the cash bonus and royalty payments. The Commissioner allowed these items, but disallowed the depletion deduction on the amount of the net profits. The Tax Court ruled that depletion on the profits should have been allowed since the lessor had an economic interest in the oil in place.

Gross income from the property, as used in Section 114 (b)(3), means gross income from the oil and gas.[1] The allowance is to the recipients of this gross income by reason of their capital investment in the minerals.[2] The allowance of percentage depletion is made only to the persons who would be entitled to claim cost depletion on account of their ownership of a depetable capital asset, the [fol. 57] fundamental theory of the allowance not having been altered by the provisions for percentage depletion.[3] The existence of a capital interest in the minerals is the

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[1] Helvering v. Mountain Producers Corp., 303 U. S. 376, 382.

[2] Helvering v. Bankline Oil Co., 303 U. S. 362, 367.

[3] United States v. Dakota-Montana Oil Co., 288 U. S. 459, 467.

sine qua non for claiming the deduction for depletion; otherwise the taxpayer has no capital investment that has suffered depletion, and is not entitled to the statutory allowance.[4]

The percentage depletion cannot exceed 27½ per cent of the gross value of the captured minerals. The nature of the interest in the deposit does not turn upon the form of the conveyance, but upon the particular consequences of the provisions for payments.[5] It is immaterial that the transfers here were accomplished by means of a lease; what is material is that the right of the taxpayer to share in the net profits was not derived from the retention of any depletable interest in the oil and gas in place.

Prior to the execution of the lease and the agreement here involved, the taxpayer (with exception of the ⅛ interest mentioned) had the entire capital investment in the underlying oil and gas. To the extent of the cash bonus and the right to royalty payments, it retained a proportionate economic interest in the oil and gas in place, and to that extent the lessees did not acquire a depletable interest,[6] but to the extent that the taxpayer granted exploration rights and an interest in the minerals in place to producers in exchange for their personal covenant to pay a share of their net profits, there was a conveyance of the taxpayer's interest in a wasting capital asset, and the producers acquired a proportionate depletable interest in the oil and gas conveyed.[7] By surrendering a partial [fol. 58] interest in the oil and gas produced from the property, the taxpayer converted a portion of its economic interest into a mere chose in action or economic advantage.[8] Thus in *Helvering* v. *O'Donnell*, 303 U. S. 370, it was held that the taxpayer who had only a contractual

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[4] Helvering v. Bankline Oil Co., supra, p. 368.

[5] Anderson v. Helvering, 310 U. S. 404, 411.

[6] Palmer v. Bender, 287 U. S. 551, 558; Murphy Oil Co. v. Burnet, 287 U. S. 299; Burnet v. Harmel, 287 U. S. 103; Bankers Coal Co. v. Burnet, 287 U. S. 308; Anderson v. Helvering, supra, p. 408.

[7] Helvering v. O'Donnell, 303 U. S. 370; Helvering v. Elbe Oil Land Co., 303 U. S. 372; Anderson v. Helvering, supra.

[8] Helvering v. Bankline Oil Co., supra, pp. 366, 367.

right to share in the net profits did not have a depletable interest.

In *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372, the reservation of the right to share in net profits by the former owner of the mineral deposits was ruled not to constitute a retention of a capital investment in the oil in place. In *Anderson* v. *Helvering,* 310 U. S. 404, the reservation of the right to share in net profits was held not to entitle the holder of such interest to a depletion allowance even though continued production was essential to the realization of such profits. There are good reasons for the rule; the depletion deduction is granted in recognition of the fact that the person having the requisite economic interest received a partial return of his capital investment when production took place.[9]

A taxpayer who leases solely for net profits no longer has a direct interest in the production of mineral deposits; his interest is in the ability of the operators to earn profits. It is true that there would be no net profits if there were no production; but since production could take place without there being any net profits, the taxpayer's income accrues after, not at the time of, the extraction of the oil and gas from the deposits. These principles have been given concrete application by this court.[10] The single depletion allowance is subject to apportionment among the parties in accordance with their economic interests.[11] Therefore, the retention of a partial interest in produc- [fol. 59] tion necessarily results in the retention of only a proportionate capital investment in the oil and gas in place.

The instant case cannot be distinguished from the *O'Donnell, Anderson,* and *Elbe Oil Company* cases on the ground that in those the right to share in the net profits was not accompanied by an interest in the minerals. Here the retention of an oil royalty in addition to a share of the net profits operated to reserve an interest in the oil

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[9] Helvering v. Bankline Oil Co., supra, pp. 366, 367.

[10] Blankenship v. United States, 95 F. (2) 507; Sneed v. Commissioner, 119 F. (2) 767, 770; Commissioner v. Caldwell Oil Corp., 141 F. (2) 559, 561; Quintana Petroleum Co. v. Commissioner, 143 F. (2) 588.

[11] Helvering v. Twin Bell Syndicate, 293 U. S. 312, 321.

in place, but it was a partial interest that was not enhanced by the personal covenant to pay a percentage of net profits. Here at the instant of production, ⅛ of the oil belonged to the former owner, 1/24 (plus an amount sufficient to pay the cash bonus) was owned by the taxpayer, and the balance belonged to the lessees. The value of each proportionate share was the gross income of each, as to which amount each was entitled to take a 27½ per cent deduction for depletion. As the court said in *Thomas* v. *Perkins,* 301 U. S. 655, 661, construing its opinion in *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, "Our opinion shows that the phrase 'income from the property' means income from oil and gas only; that where the lessee turns over royalty oil in kind to the lessor, the amount retained by the lessee is the basis for his computation of depletion and the royalty oil is the basis for that allowable to the lessor."

The respondent claims, and the Tax Court held, that its gross income from the property was "clearly the proceeds from the 1/6 [should be 1/24] royalty interest which petitioner retained in the lease and the 20 per cent annual profits which it received from the operator of the lease under the contemporaneous agreement amounting in 1940 to $26,223.70." In other words, the claim is that a net profit is gross income if paid by the lessee to the lessor of oil property. This would not be so, it is admitted, if the [fol. 60] lessor had not reserved in the lease a royalty interest that entitles it to some percentage depletion. The argument is that this reservation converts a net profit into a bonus and distinguishes this case from the *O'Donnell* and similar cases above cited; but there is no difference in the controlling legal principle that underlies them all. The payment of net profits to the lessor is not the payment in kind of royalty oil or its equivalent.

A bonus is subject to percentage depletion upon the theory that it is an advance royalty; but net profits are not paid in advance, and cannot be paid until they are earned and ascertained. Gross income, under the statute, is exclusive of any rents or royalties paid or incurred by the taxpayer. If, therefore, net profits are held to be rents or royalties within the meaning of Section 114(b)(3), the depletable gross income thereunder cannot be ascertained until we determine the amount of the net income. Under the present state of the law, the depletion allowance of

27½ per cent is granted upon the gross income from every barrel of oil captured, which allowance is apportioned *pro rata* among those who own the oil itself.[12] Gross income of the royalty owners is the full amount of their royalty, and gross income of the lease operator is the total production less the royalties. Under the terms of the lease here involved, 5/6 of the oil and gas was owned by the producers, 1/8 by the former owner, 1/24 by the taxpayer; and the depletion upon gross production was, and should have been, apportioned accordingly.

If net profits, which cannot be computed or paid until they are earned, are rents and royalties within the meaning of Section 114(b)(3), the depletion allowances on the working interest cannot be ascertained until the amount [fol. 61] of net income is determined. This poses an abstruse problem instead of the rule of thumb that the arbitrary percentage-depletion allowance was intended to be.[13] To extend the allowance to include 27½ per cent of the net profits paid to the lessor by the lessees "would give rise to problems of considerable perplexity and would create administrative difficulties which it was intended to overcome by laying down a simple rule which could be easily applied."[14]

In addition, it would be a departure from the theory upon which bonus payments are depletable, since no economic interest in the oil in place was reserved by the lessor to represent the contingency of net profits that might be earned. On the contrary, the lessor accepted the personal covenant of the lessees to pay whatever amount of net profits became due by the lessees. This entailed upon the lessor the financial risk of the lessees' personal ability to earn profits and to account for them. For these reasons we conclude that the doctrine of advance royalty payments cannot be extended to net profits.

The decision of the Tax Court is reversed, and the cause remanded for further proceedings not inconsistent with this opinion.

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[12] Helvering v. Twin Bell Syndicate, 293 U. S. 312; Thomas v. Perkins, 301 U. S. 655.

[13] Helvering v. Twin Bell Syndicate, 293 U. S. 312, 321; Helvering v. Producers Corporation, 303 U. S. 376, 381.

[14] Helvering v. Producers Corporation, supra.

HUTCHESON, Circuit Judge, Dissenting:

Believing that the Tax Court is clearly right and that the opinion of the majority completely misconceives both the facts and the law, I think it well, in order to point this out, to fully state the facts which control the decision of this case and restate the controlling principles.

[fol. 62] Taxpayer, the fee owner of two tracts of oil bearing land, leased them in 1927 for a cash bonus, an oil royalty of one-sixth, and oil payments of 20 percent to be paid out of the net profits from production. Oil was discovered in 1932, and in 1935, 1936, 1937, 1938, 1939 and 1940, taxpayer received out of production its royalty and also payments on account of the 20 percent it had reserved. Of the opinion that all of the payments made to it out of production were a return of its capital interest in the oil in place, taxpayer, on the authority of *W. S. Green*, 26 B. T. A., 1017, a precisely similar case, claimed, and for 1935 through 1939 was allowed, depletion of them all. For 1940, the tax year in question here, the commissioner allowed the depletion on the one-sixth royalty, but denied it on the oil payments on the ground that these were not payments out of an interest in oil reserved by taxpayer but were mere cash payments on an outright sale of the minerals it owned,

The Tax Court took a different view. It found,[1] on a record which fully supports the finding, that, by the leasing arrangements, lessor retained an economic interest in the minerals in place, and provided for its return out of production, in part through the one-sixth royalty, and in part through the 20 per cent payments. It held, on considerations which I think cannot be gainsaid, and on an analysis of the authorities which I find unanswerable, that these payments were not cash payments agreed upon as the purchase price for an outright sale, but oil payments out of production of oil in which taxpayer had, to the extent of royalty and payments, retained an economic interest. It rejected the commissioner's disallowance and ordered the deficiencies redetermined accordingly.

The commissioner, pointing with unwavering finger at the words, "net profits" realized by lessees from their [fol. 63] operation of the lease, used by the parties as the measure of the payments out of production, is here insisting

[1] 2 T. C. 1258.

that the cases he cites [2] require a reversal of the Tax Court's ruling.

Taxpayer is here insisting that this is just another of the all too many cases in which a too intense preoccupation by the commissioner with words as formulas, here "net profits", coupled with a complete disregard of the controlling facts existing and found by the Tax Court as to what the parties intended to do and did do, has led the commissioner astray. He points out that the cited cases, except *Commissioner v. Caldwell*, 141 F. (2) 559, which taxpayer insists supports it and not the commissioner, dealt with situations in which it was clear that the taxpayer, reserving no economic interest in the minerals in place, but, by outright sale, parting with all of them, had made provisions, sometimes in one way and sometimes in another, merely for payments in cash of the consideration for the sale. He insists that the situation here is quite different in fact, and the controlling cases are: *Thomas v. Perkins*, 301 U. S. 655; [3] *Spalding v. U. S.*, 97 F. (2) 697; *Commissioner v. Felix*, 144 F. (2) 276; and *Commissioner v. Caldwell*, 141 F. (2) 559, where, as here, there was no outright sale but merely a leasing of the property for oil development with a provision for return to the lessor of the interest it had reserved, in part through a bonus, in part through a fixed royalty, and in part through fixed payments out of the production of oil.

I think it clear that the Tax Court was right. The most cursory examination of the contracts which effected the [fol. 64] leasing arrangement [4] discloses that the words "net

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[2] Helvering v. O'Donnell, 303 U. S. 370; Helvering v. Elbe, 303 U. S. 372; Anderson v. Helvering, 310 U. S. 404; Blankenship v. U. S., 95 F. (2) 507; Quintana Petroleum Co. v. Comm., 143 F. (2) 588; and Comm. v. Caldwell, 141 F. (2) 559.

[3] Cf. the thoughtful analysis and application of that case in Anderson v. Helvering, 310 U. S. at pp. 409-13.

[4] These arrangements provided for the royalty and made the ordinary provisions carried in oil lease contracts. In addition, after providing that the lessees should have exclusive charge of all operations to be conducted on the land as well as the payment of rentals, royalties, taxes and other charges which may become due, the contract went into most

profits" were used merely as a shorthand way of saying that Kirby's part of the gross production was to be 20 percent, less, however, 20 percent of the charges and expenses of operation as provided in the agreement. Thus, in fact and in legal effect, the agreement was the same as if it had in terms provided that lessor retained, and was to have, 20 percent of the gross profits from production, subject, however, to the payment of 20 percent of the speci- [fol. 65] fied expenses, and the 20 percent payment it received constituted, under *Helvering v. Producers*, 303 U. S. 382, the "gross income" on which its depletion must be taken. Cf. *Commissioner v. Felix*, 144 F. (2) 276.

That the parties intended by the leasing contracts, not an outright sale of the properties but to provide for the retention by taxpayer of an interest in the oil in place is suggested by even the most superficial view of the contracts and the circumstances attending their making and carrying out. The assembling and analysis of the significant facts found by the Tax Court leaves me in no doubt that

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careful detail as to the costs and expenses which were to be charged to the joint account. Providing "no home office or other overhead charge shall be made to the joint account in connection with the operation of premises", it provided: for a fixed bookkeeping and expense charge; that material should be charged at cost; and otherwise made it clear that though lessee was to be the operator of the premises and was to make payments to lessor equivalent to 20 percent of the net profits therefrom, the operation was for joint account.

Clause IV provided: "First Party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, *and in which the parties hereto may be interested*", (emphasis supplied). "Upon the sale of any such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales. * * *".

Clause V provided: "The total net profits (or total net loss as the case may be) shall be determined by deducting the total *charges made against the lease as authorized herein from the total credits allowed the lease as authorized herein* Second Party shall participate in *the profits derived from the sale of the oil and gas and other mineral production* of

taxpayer is entitled to the depletion. Taxpayer was the owner in fee of the property, and it did not sell it outright for a price to be paid in cash, but, on the contrary, leased it for a royalty and a bonus to be paid, part in cash and part from future production. It neither received nor contracted to receive any cash as the purchase price, but only as bonus, that is as advanced royalty, as royalty and as oil payments. It carefully guarded the ascertainment of the net profits through the receipt of which it was to recover part of its reserved capital by specifying what charges should be made and how they were to be made. To remove from any doubt the fact that taxpayer had retained an interest in the property, the contract, though providing that first party should have exclusive charge of operations as well as the payment of rentals, royalties and other charges, in Clause IV declared: "First party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, and in which the parties

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the lease embraced in this agreement only after *all charges and debits and costs* of producing profits shall have been paid and provided for. It is expressly agreed that First Party shall have the right to carry forward any loss from operations as a charge against the net profit account for the next and succeeding months until such loss has been wiped out and paid.". (Emphasis supplied.)

Clause VI provided that First Party should keep an accurate record of all accounts, which record should be available at all times for examination and inspection by second party, and "Second Party shall also have access at all reasonable times to the well and production records and reports relating to said premises." First party was required within one month after the close of each calendar month to furnish Second Party with statement of authorized expenses incurred and charges made and authorized credits made. It provided finally that within one month after the close of each calendar month Second Party shall be paid its 20 percent of the net money profits derived from the operation of the lease as calculated and determined under the terms hereof.

Clause IX provided: *"This Contract Shall Be Binding upon the Parties Hereto and Their Respective Successors in Interest"*. (Emphasis supplied.)

hereto may be interested". Clause V provided: "Second Party shall participate in the profits derived from the sale of the oil and gas and other mineral production of the lease only after all charges and debits and costs of producing profits shall have been paid and provided for". Finally, the Ninth clause, providing that the contract shall be bind-[fol. 66] ing on the parties and their successors, makes it entirely clear that it did not impose a mere personal obligation, but, on the contrary, fixed a charge upon the property to protect the interest, taxpayer had retained. If, as the commissioner claims, the lessor had no interest in the premises or in the production, what was there to bind the successors to? If the contract was merely a personal agreement to pay money, what was the office of the clause?

It will serve no useful purpose for me to analyze each of the cases cited by the commissioner. The Tax Court has sufficiently distinguished them. It is sufficient to say that some of them are not depletion cases at all. In most the issue was who owned the production, that is to whom it was taxable as ordinary income. The commissioner does not contend that the 20 percent payments are taxable as ordinary income to the lessees and not to the taxpayer, as was successfully contended in some of the cases commissioner cites, and as would be the case here if the commissioner is right. Quite to the contrary, he accepts them as ordinary income as they were returned by Kirby, and insists on taxing them as such. As *Anderson v. Helvering*[5] makes clear, if Kirby is not entitled to depletion on these payments, it is because they are the income of the operators and taxable to them. Pointing out that it is the substance of what has occurred which determines who is the owner of, and there-

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[5] "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest. Helvering v. Bankline Oil Co., 303 U. S. 362, 367; Helvering v. O'Donnell, 303 U. S. 370; Helvering v. Elbe Oil Co., 303 U. S. 372; Thomas v. Perkins, 301 U. S. 655, 661, 663; Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 321; Palmer vs. Bender, 287 U. S. 551. Cf. Helvering v. Clifford, 309 U. S. 331."

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fore the payer of taxes on, income from oil production, it makes clear that what is significant in determining this is whether a person, who has owned land and has dealt with [fol. 67] reference to the minerals under it, has sold the minerals outright and is looking to the production, if at all, merely as a measure of the cash payments for the sale, or whether he has intended to reserve, and has reserved, in any form, an interest in the minerals and is looking, to recover it, to the production. Discussing and analyzing the different situations in which this question has been presented to the courts, the Court makes it clear that just as royalties are, cash bonuses, *Burnet v. Harmel*, 287 U. S. 103, and oil payments, *Thomas v. Perkins*, 301 U. S. 655, are entitled to depletion. Declaring that the decision in *Thomas v. Perkins* did not turn upon the particular instrument involved nor upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type, it pointedly reaffirmed the depletability of oil payments. Saying that the circumstances urged by the commissioner, that the provision for oil payments in the case under decision was not phrased in terms of a reservation and that the payments were to be in cash rather than directly in oil, are without significance in determining the issues presented for decision, the court denied depletion there because, and only because, the claimant there was not entirely dependent for the deferred payments upon the production of oil, but had a right to look also to sales of the fee.

Helvering v. Anderson makes it plain that there is no difficulty about the principle to be applied. The difficulty comes only in its attempted application. All agree that an outright sale of oil without reservation of an economic interest does not entitle the seller to depletion on partial payments of the purchase price. No case holds differently. No one really contends differently. If what was done here was in fact not to reserve an interest in the production, the commissioner is right, while if what was done was, as the Tax Court has found and held, to reserve such an interest, taxpayer is right. The Tax Court has found as a fact that [fol. 68]. by their agreements for leasing the parties arranged that lessor was to have out of the production a cash bonus, a royalty, and additional payments out of 20 per cent of the net profits. *Helvering v. Anderson* makes it plain, too, that the Tax Court was right in holding, as it

did in *Commissioner v. Felix, supra,* that a provision for 50 percent of the net profits, and, as it did in *Commissioner v. Caldwell, supra,* that a provision for all of the net profits until certain amounts were paid back, entitled the owner of the oil payments to depletion, and that the courts were right in those cases in affirming the Tax Court. It also makes it plain that the Tax Court was right in allowing depletion here, and that its judgment should be Affirmed.

[fol. 69] JUDGMENT

Extract from the Minutes of March 5th, 1945

No. 11065

COMMISSIONER OF INTERNAL REVENUE,

versus

KIRBY PETROLEUM COMPANY

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of the Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that the decision of the said Tax Court of the United States in this cause be, and the same is hereby, reversed; and that this cause be, and it is hereby, remanded to the said Tax Court of the United States for further proceedings not inconsistent with the opinion of this Court.

"Hutcheson, Circuit Judge, dissents."

[fol. 70] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 71] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed May 21, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Endorsed on Cover: Enter Homer L. Bruce. File No. 49592. U. S. Circuit Court of Appeals, Fifth Circuit. Term No. 56. Kirby Petroleum Company, Petitioner, vs. Commissioner of Internal Revenue. Petition for writ of certiorari and exhibit thereto. Filed April 9, 1945. Term No. 56, O. T. 1945.

(9441)

FILE COPY

No. [redacted] 56

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

KIRBY PETROLEUM COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND SUPPORTING BRIEF

HOMER L. BRUCE,
Attorney for Petitioner.

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IN THE

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OCTOBER TERM, 1944

KIRBY PETROLEUM COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

May it Please the Court:

Petitioner, Kirby Petroleum Company, respectfully prays for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit at New Orleans, Louisiana, to hear this cause and to review the decision of the Circuit Court of Appeals in reversing the judgment of the Tax Court of the United States. Petitioner respectfully shows to this Honorable Court:

1.

Summary Statement of the Matter Involved.

This case was tried before the Tax Court on the

pleadings (R. 4-15) and stipulation (R. 32-34).

Petitioner owned the *fee title* to a tract of land except that there was outstanding a 1/8 interest in the minerals. On September 29, 1927, it executed a regular oil and gas mineral lease (R. 35-41) upon the property, reserving a royalty of 1/6 on oil and in substance 1/6 on the amount realized from the sale of gas. Out of its 1/6 royalty it absorbed the outstanding 1/8 interest so that its gross royalty was a net 1/24 (R. 6, par. (A) (6)). On the same day it executed an agreement (R. 42-50) with the lessees, which recited the execution of the lease and provided that the lessees should also pay petitioner 20% of the net profits derived by the lessees from their operations under the lease and then provided in detail for the accounting procedure in the determination of the net profits. Both the lease and the agreement were executed by George Sawtelle, a Vice-President of petitioner. It was stipulated (R. 33) that he, if sworn, would testify that petitioner would not have executed the lease unless the lessees had also executed the contemporaneous agreement as a part of the consideration for petitioner's executing the lease, and that the lessees did execute the agreement as part of the consideration for petitioner's executing the lease, and that the petitioner also received upon the execution of the lease a cash bonus from the lessees for executing the lease. This testimony was uncontradicted.

Production was obtained in 1932 and in 1935 petitioner received its first payment under its net profits agreement, and received such payments of profits for

each year through 1940, the year involved. For 1940 its part of the net profits was $26,223.70 and in its income tax return for that year it deducted as depletion 27½% of this amount. The Commissioner disallowed this depletion deduction (R. 33). The Commissioner did not question its deduction for depletion on its 1/24 royalty.

Petitioner appealed to the Tax Court on this one point. The Tax Court in its opinion and decision (R. 16-23) held that petitioner was entitled to the depletion allowance, and held that in granting the lease the petitioner retained for itself the 1/6 oil royalty and 20% net profits from the operation of the lease each year. The Circuit Court of Appeals reversed the judgment of the Tax Court and apparently held that, although petitioner to the extent of the cash bonus and the 1/6 royalty retained an economic interest in the oil and gas in place, it nevertheless surrendered all of its other interest and retained no economic interest in the oil and gas in place by virtue of which it received 20% of the net profits and received this merely as a result of its having a chose in action or economic advantage (R. 54).

Circuit Judge Hutcheson filed a dissenting opinion, holding that the Tax Court should be affirmed and that petitioner was entitled to the depletion allowance on the net profits to the same extent as it was on the 1/6 royalty.

2.

Statement Disclosing Basis Upon Which It Is Contended This Court Has Jurisdiction.

The jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

The judgment of the Circuit Court of Appeals was entered March 5, 1945 (R. 66.)

3.

Questions Presented.

1. When the Tax Court had found that the execution of the lease and contract was in substance all one transaction, that the petitioner in granting the lease retained for itself a royalty equivalent to 1/6 of the gross and 20% of the net profits, and that petitioner had an economic interest in the oil in place and was entitled to depletion on the 20% net profits received, was the Circuit Court of Appeals authorized to disregard these findings of fact and find the transactions were separate, that the 20% did not represent any retained royalty, that petitioner did not retain any economic interest and that petitioner was not entitled to depletion on the 20% net profits receipts?

2. Was the petitioner entitled to depletion on the amount received by it under the 20% net profits provision?

4.

Reasons Relied on for the Allowance of the Writ.

The reasons relied on for the allowance of the writ are that the Circuit Court of Appeals has decided important questions of Federal law which have not been and should be settled by this Court, that these questions have been decided in a way probably in conflict with the applicable decisions of this Court, and that they have been decided in a way directly in conflict with the decision of the Ninth Circuit Court of Appeals in *Commissioner of Internal Revenue v. Felix Oil Company*, 144 F.2d 276.

(1) The Tax Court held that the execution of the lease reserving a 1/6 royalty and of the contract providing for 20% of the net profits was one transaction, that petitioner in granting the lease reserved both the 1/6 royalty and the 20% of the net profits, that petitioner retained an economic interest in the oil represented by the 20% net profits, and that petitioner's "gross income from the property" within the meaning of Section 114 (b) (3) of the Internal Revenue Code was the proceeds of both the 1/6 royalty and of the 20% net profits, and therefore it was entitled to depletion on the net profits proceeds. The Circuit Court of Appeals disregarded these findings of fact and the inferences of fact drawn by the Tax Court and substituted its own contrary to the proper rule laid down by this Honorable Court in *Wilmington Trust Company, Executor v. Helvering*, 316 U. S. 164; *Dobson v. Commissioner*, 320 U. S.

489, and *Choate v. Commissioner,* 65 S. Ct. 469, (decided January 29, 1945).

(2) The Circuit Court of Appeals in denying petitioner depletion on the proceeds of its 20% of the net profits is in direct conflict with the holding of the Ninth Circuit Court of Appeals in *Commissioner of Internal Revenue v. Felix Oil Company,* 144 F.2d 276. In the latter case the landowner executed a lease and the only royalty reserved was 50% of the net profits and the Ninth Circuit Court of Appeals held the landowner was entitled to depletion on the proceeds of the 50% of the net profits. The holding of the Circuit Court of Appeals is also contrary to the fundamental holdings of this Court on matters of depletion in *Burnet v. Harmel,* 287 U. S. 103; *Murphy Oil Company v. Burnet,* 287 U. S. 299, and *Palmer v. Bender,* 287 U. S. 551, and its actual decisions in the so-called net profits cases of *Helvering v. O'Donnell,* 303 U. S. 370, and *Helvering v. Elbe Oil Land Development Company,* 303 U. S. 372, and in the cases of *Helvering v. Bankline Oil Company,* 303 U. S. 362, and *Anderson v. Helvering,* 310 U. S. 404.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari may issue out of and under the seal of this Honorable Court directed to the United States Circuit Court of Appeals for the Fifth Circuit commanding said court to certify and send to this Court on a day certain, to be therein designated, a full and complete transcript of the record of all of the proceedings in the Circuit Court of Appeals in said cause entitled *Commissioner of*

Internal Revenue, Petitioner, v. Kirby Petroleum Company, Respondent, No. 11065 on its docket, to the end that said cause may be reviewed and determined by this Court as provided by Section 240 of the Judicial Code, as amended, and that your petitioner may have such other and further relief or remedy in the premises as this Court may deem appropriate and in conformity with the provisions of the Judicial Code, and that on hearing before this Honorable Court said judgment of the Circuit Court of Appeals be reversed.

KIRBY PETROLEUM COMPANY,
By HOMER L. BRUCE,
Attorney for Petitioner.

No.................................

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

KIRBY PETROLEUM COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

I.

The Opinions of the Courts Below.

The opinion of the Tax Court is found at page 16 of the record and is reported in 2 T. C. 150. The opinion of the Circuit Court of Appeals has not been reported but is found at page 54 of the record.

II.

Jurisdiction.

Stated under heading 2 of the petition.

III.

Statement of the Case.

A full statement of the case has been given under heading 3 of the petition and in the interest of brevity is not repeated.

IV.

The Law.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

> (m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *
>
> (26 U. S. C. 1940 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b)—*Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells, the allowance for depletion under Section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 1940 ed., Sec. 114.)

V.

Specification of Errors.

1. The Circuit Court of Appeals erred in substituting its findings of fact and inferences of fact contrary to those of the Tax Court and in thereby holding that petitioner was not entitled to depletion on the proceeds of the 20% net profits.

2. The Circuit Court of Appeals erred in holding that petitioner was not entitled to the depletion allowance on the amount received by it under the pro-

vision of its contract that it was to receive 20% of the net profits from the operation of the properties.

ARGUMENT.

Summary of the Argument.

Point A.

The Circuit Court of Appeals had no authority to make findings of fact and inferences of fact contrary to those of the Tax Court and thereby hold petitioner was not entitled to the depletion claimed.

Point B.

Petitioner at all times had an economic interest in the oil and gas produced and was entitled to the depletion allowance on the amount received by it under the 20% of net profits provision.

Point A.

The Tax Court in its opinion, after setting out the facts, summarized the contentions and distinctions made by petitioner (R. 19-20) and concluded in that part of its opinion as follows (R. 20):

> "In the instant case petitioner lays emphasis on the fact that it was the owner in fee simple of two tracts of land and leased them to Humble and to Marland for development and operation and that in granting the lease it retained for itself a 1/6 oil royalty and 20 percent net profits from the operation of the lease each year. Respondent has not disputed petitioner's right to percentage depletion on the 1/6 oil royalty reserved in the lease ~~but does~~ dispute petitioner's

right to percentage depletion on the $26,223.70 net profits which petitioner received in 1940 from operations.

"Petitioner contends that it is as much entitled to depletion on this $26,223.70 as it is on the receipts from its 1/6 oil royalty and distinguishes its situation from that which existed in *Helvering v. O'Donnell, supra,* and *Helvering v. Elbe Oil Land Developing Co., supra,* and *Anderson v. Helvering, supra,* on the grounds which we have already stated. We agree with petitioner in the distinction which it draws."

In discussing what was the gross income under Section 114 (b) (3) of the Internal Revenue Code, the Tax Court said (R. 21):

"What is petitioner's 'gross income from the property' in 1940 within the meaning of Section 114 (b) (3) and which it must include in its gross income for income tax purposes? We think it is clearly the proceeds from the 1/6 royalty which petitioner retained in the lease and the 20 percent annual profits which it received from the operation of the lease under the contemporaneous agreement amounting in 1940 to $26,223.70. If this view is correct, then petitioner is entitled to percentage depletion on the amounts received from its part of the profits as much as from the amounts received from its retained 1/6 oil royalty."

Judge Hutcheson in his dissenting opinion agreed with this analysis by the Tax Court, but the majority of the Court held that the lease and contract were entirely different transactions, that the peti-

tioner reserved an economic interest represented by its 1/6 royalty but had no economic interest represented by the 20% of net profits, and for that 20% "accepted the personal covenant of the lessees to pay whatever amount of the net profits became due by the lessees."

This Court in *Dobson v. Commissioner,* 320 U. S. 489, held that a determination of the Tax Court as to whether particular transactions are integrated or separated for tax purposes is no more reviewable than any other question of fact. Here the Tax Court held that the lease and contract were for tax purposes all one transaction and agreed with petitioner's contention "that in granting the lease it (petitioner) retained for itself a 1/6th oil royalty and 20 per cent net profits from the operation of the lease each year" and that petitioner's gross income for depletion purposes was the 1/6th royalty and the 20% profits. These findings and the other findings were binding upon the Circuit Court of Appeals under the decisions of this Court in *Dobson v. Commissioner, supra; Wilmington Trust Company v. Helvering,* 316 U. S. 164, and *Choate v. Commissioner of Internal Revenue,* 65 S. Ct. 469, decided January 29, 1945. Such a rule is particularly salutary in a case like this in the interest of uniformity in applying the tax law. We refer particularly to the discussion on this in the footnote at page 499-500 of 320 U. S. in this Court's opinion in *Dobson v. Commissioner.* As far back as 1932 the Board of Tax Appeals held[1] that where a landowner

[1] *Green v. Commissioner,* 26 B. T. A. 1017.

leased his land and obtained a royalty of a certain per cent of the net profits, he was entitled to depletion thereon. The Commissioner acquiesced in that case in 1933[2] and did not contend to the contrary until 1942 in the *Felix Oil Company* case[3]. Both the Board of Tax Appeals and the Ninth Circuit held again that the landowner was entitled to depletion on the net profits reservation. The Tax Court in the present case made the same findings and for the sake of uniformity in the administration of the taxing statutes, the Circuit Court of Appeals under the authorities of this Court above referred to should not have substituted its own findings and inferences of fact for those of the Tax Court.

Point B.

The decision of the Circuit Court of Appeals in this case is in direct conflict with the holding of the Ninth Circuit Court of Appeals in the *Felix Oil Company* case[4]. In that case the Company owned certain acreage in fee and executed an oil and gas lease on it, but, instead of retaining a gross royalty, it retained only the right to receive 50% of the net profits. The Commissioner argued there, as here, that the Oil Company had sold the property and was entitled to no depletion. The court pointed out that the agreement

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2XII-1 C. B. 6.

3Memorandum Decision by the Tax Court of December 18, 1942, not published in the regular reports but found as C. C. H. Decision 12,920-A of Commerce Clearing House, Inc.: Tax Court Service, and affirmed by the Ninth Circuit Court of Appeals in 144 F. 2d 276 from which the Commissioner took no appeal.

4*Commissioner v. Felix Oil Company*, 144 F. 2d 276.

was like an ordinary oil and gas lease with rights of forfeiture in the landowner for failure to develop, etc. The court then said, in rejecting the Commissioner's contention:

> "We see no reason for rejecting this interpretation of the contract. It is clear that the taxpayer retained an economic interest in the oil in place. It had a capital investment in the land and in the paying wells, and the income it received from production was not, we think, income arising from a sale of the oil before severance. Cf. Palmer v. Bender, 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489; Helvering v. Elbe Oil Land Development Co., supra; Helvering v. Mountain Producers Corporation, 303 U. S. 376, 58 S. Ct. 623, 82 L. Ed. 907. In the case last cited the Supreme Court said (303 U. S. at page 382, 58 S. Ct. at page 625, 82 L. Ed. 907) that 'the term "gross income from the property" means gross income from the oil and gas * * * and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned'."

This Honorable Court should grant a writ of certiorari in this case, if for no other reason, so that this conflict between the Ninth and Fifth Circuits may be resolved.

As to the merits of the case, we respectfully refer to the dissenting opinion of Judge Hutcheson in this case as it succinctly sets forth the views of petitioner.

The purpose of the depletion allowance is to allow an owner of an interest in the minerals to recover

his cost thereof through his income from the minerals. In the case of *Felix Oil Company* the landowner could never recover any part of his costs of the minerals unless it were allowed depletion as all it reserved was an interest in the net profits, but it was entitled to those net profits because of its ownership in the minerals. In this case petitioner leased the land for a fractional royalty measured by gross production and a fractional royalty measured by net profits. It was all one income to petitioner which it obtained because it owned the minerals and was willing to execute a lease on these terms. In view of the record and of the findings of the Tax Court the lease and contract were all one transaction and are to be treated as if they were one instrument reserving a royalty of 1/6 of the gross and 20% of the net profits. We refer to the analysis of the contract set forth in footnote 4 of Judge Hutcheson's opinion, where he shows that under clause IV of the contract the lessor and lessee were both interested in all oil to be marketed from the premises and that this was not a mere personal obligation on the part of the first lessees but was a contract that was binding upon their successors in interest in the lease.

The opinion of the Circuit Court of Appeals says that the present case cannot be distinguished from the *O'Donnell, Anderson* and *Elbe Oil Company* cases[5]. We will refer to them later in this brief.

This Court in every case has held that, where a party owned an economic interest in the oil and gas

[5]*Helvering v. O'Donnell*, 303 U. S. 370; *Anderson v. Helvering*, 310 U. S. 404; *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372.

as distinguished from merely an economic advantage through a contract, he was entitled to the depletion allowance through which to recover his capital investment, and the test laid down by this Court is whether such a party does have an economic interest in the minerals.

In two of the earlier cases[6], this Court held that a landowner upon executing a lease was entitled to depletion upon both the bonus and the royalties as a source from which to recover his capital investment in the minerals.

In the next case[7] this Court had before it the question of whether a lessee, who upon assigning a lease received a cash bonus and retained an oil payment and an overriding royalty, was entitled to depletion on these items. This Court first referred to the nature of the lessor's right to depletion, saying on page 557:

> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. See Burnet v.

[6] *Burnet v. Harmel*, 287 U. S. 103; *Murphy Oil Company v. Burnet*, 287 U. S. 299.

[7] *Palmer v. Bender*, 287 U. S. 551.

Harmel, supra; Bankers Pocahontas Coal Co. v. Burnet, ante, p. 308."

It then referred to the specific case before it and, in holding the lessee-assignor entitled to depletion, said on page 558:

> "Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."

The *Bankline Oil Company case*[8] is not even comparable to the present one. The taxpayer operated a casinghead gasoline plant for the extraction of gasoline from wet gas, and the only connection that it had with any production was that it had two types of contracts with producers of gas, under one of which the gas was delivered to the taxpayer who extracted the gasoline and agreed to pay the producer 1/3 of

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8*Helvering v. Bankline Oil Company*, 303 U. S. 362.

the gross proceeds from the sale of the gasoline or to deliver to him 1/3 of the gasoline, and under the other the taxpayer purchased outright from the producer all the natural gas and agreed to pay the producer 1/3 of the gross proceeds received from the sale of the extracted gasoline. There the taxpayer never had any remote interest in the minerals in place.

The *O'Donnell* case[9] was the first so-called net profits case decided by this Court. The taxpayer there never had any interest at any time in the oil and gas. He merely owned part of the stock of the San Gabriel Petroleum Company, which he sold to Petroleum Midway Company, Ltd., and, as consideration for the payment for the stock, the Midway Company agreed to acquire the properties of the San Gabriel Company and pay the taxpayer 1/3 of the net profits from the operation of those properties. That is a far cry from the present case where petitioner was the landowner ~~and~~ in substance made a lease retaining a royalty measured by the gross production and another royalty measured by the net profits.

In the next so-called net profits case[10], which the lower court says cannot be distinguished from the present case, taxpayer did own an interest in certain oil and gas properties, but it made an absolute sale of all of its interest in those properties for $350,000 cash, $1,650,000 additional cash payable over a period of four years, and for the additional agreement by the

[9] *Helvering v. O'Donnell*, 303 U. S. 370.

[10] *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372.

purchaser to pay taxpayer 1/3 of the net profits resulting from the operation of the properties after the purchaser had recovered all its expenditures in the acquisition, development and operation of the properties. **As pointed out by this Court on page** 374, the agreement specifically provided that:

> "It is the intention of the parties to this agreement that the full ownership, possession and control of all the properties * * * shall be vested in Honolulu (purchaser) and Elbe shall have no interest in or to said properties * * * ."

This Court simply held that, after the execution of such contract, the taxpayer had no further interest in the properties and received its net profits as part of the consideration for a sale of its interest.

In the third case that the lower court says cannot be distinguished[11] the owner of certain royalty interests, fee interests and deferred oil payments, sold the same to a purchaser for $50,000 cash and $110,000 to be paid from one-half the proceeds received by the purchaser from oil and gas produced from the properties and from the sale of the lands owned in fee, the lesser retaining a lien upon all of the properties. The question involved was whether the *purchaser* should be required to include in his income the entire proceeds received from the oil and gas produced although one-half was paid to the seller. This Court held that this was a completed sale of the properties, that the purchaser obtained the entire interest and that the payments to the seller were merely by way

[11] *Anderson v. Helvering*, 310 U. S. 404.

of purchase price. We cannot see the applicability of that case to the present one.

One last case[12] will be referred to. Taxpayer owned certain leases and made a contract with an oil company under which the oil company was granted the right to go upon the leased properties, drill wells thereon and produce all the oil and gas therefrom at its own expense. The contract then provided that all the oil and gas should be delivered to the taxpayer, who would sell the same and pay the oil company two-thirds of the net proceeds, with the provision that if the lessor took its royalty of 5% in oil, the taxpayer would pay the oil company 61 2/3% of the net proceeds. In that case the taxpayer was actually obtaining one-third of the net proceeds from the operation of the property with all operations and expenses being borne by the oil company. The taxpayer claimed the right to take depletion on the entire production instead of on one-third. The Government did not even contest the right to take depletion on the one-third but denied the depletion on the two-thirds because the oil company was the one entitled to depletion on that part, and the court sustained the position of the Government. It will be noted in that case that the taxpayer was allowed the depletion on the one-third interest owned by taxpayer.

In this case respondent owned the minerals in fee and at all times came more clearly within the economic interest test laid down by this Court than many taxpayers who have been allowed by this Court to take

12 *Spalding v. U. S.*, 97 F. 2d 697.

depletion. Respondent was willing to make a lease but wanted to recover its capital investment in the property through a participation in the returns from the production of the depletable minerals. This took the form of a cash payment, a retained royalty and a participation in the net profits. The provision concerning net profits was merely a method of determining the part of the minerals or their proceeds that should be paid to the respondent as the owner of the minerals in fee. In the preambles to the supplementary agreement, after a reference to the lease, it is recited:

> "The parties to said lease have agreed that Second Party shall be entitled to receive twenty per cent (20%) of the net money profits derived by First Party from operations under said lease, said twenty per cent (20%) net money profits interest being specifically described and defined and payable as is hereinafter provided." (R. 42.)

Paragraph I of the contract then provided:

> "Second Party, subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty per cent (20%) of the net money profits realized by First Party from its operations under and by virtue of the lease referred to above. The net money profits in which Second Party shall participate under the terms hereof, shall be calculated and determined and be payable as hereinafter provided." (R. 43.)

The contract then contained detailed provisions as to the determination of the net profits.

This contract and the lease merely provided for the total return by way of income from the production of petitioner's minerals that petitioner was to receive. It received this total amount because of its fee ownership of the minerals. Certainly, no one can have a greater economic interest in minerals than the fee owner thereof, and it is respectfully submitted that petitioner under every test laid down by the courts is entitled to the 27½% depletion upon the amounts received by it under the 20% net profits agreement.

We refer briefly to the statement of the court below that, if depletion were allowed on the net profits, the depletion could not be ascertained until the amount of net income is determined and that "This poses an abstruse problem instead of the rule of thumb that the arbitrary percentage-depletion allowance was intended to be." We see no abstruse problem involved. The statute says that petitioner will be allowed a depletion of 27½% of its gross income. We see no difficulty in computing the 27½% allowance upon the income that was received by petitioner from the 20% provision. The amount received in the year involved was $26,223.70, and 27½% of that was $7,211.52. (R. 33.) Judge Hutcheson in his dissenting opinion found no difficulty in determining petitioner's allowance on this basis, saying "the 20 per cent payment it received constituted, under *Helvering v. Producers*, 303 U. S. 382, the 'gross income' on which its

depletion must be taken." We see no abstruse problems or involved administrative difficulties that might arise.

Conclusion.

It is respectfully submitted that this case is such as to call for the exercise by this Court of its supervisory powers, and we, therefore, respectfully pray that the petition for writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit be granted.

Homer L. Bruce,
Attorney for Petitioner.

FILE COPY

No. 1139 56

IN THE

Supreme Court of the United States

October Term, 1944

KIRBY PETROLEUM COMPANY, *Petitioner*,
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

HOMER L. BRUCE,
Attorney for Petitioner.

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No. 1139

IN THE

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October Term, 1944

KIRBY PETROLEUM COMPANY, *Petitioner*,
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

May it Please the Court:

Since petitioner filed its petition for writ of certiorari in this case, the Circuit Court of Appeals for the Ninth Circuit in *Commissioner of Internal Revenue v. Anna Vickers Crawford,* No. 10,885 on the docket of that court, has affirmed on April 21, 1945, the memorandum decision of the Tax Court in that case, which may be found in Commerce Clearing House Tax Court Service, Decision No. 13,837(M). We attach a copy of the opinion of the Circuit Court of Appeals in the *Crawford* case. In that case taxpayer was the owner of certain land, just like the petitioner in this case, and executed an oil and gas lease retaining the royalty measured in part by the gross production and in part by the net profits of

the lessee. The Commissioner disallowed depletion on the taxpayer's part of the royalty measured by the net profits. Both the Tax Court and the Circuit Court of Appeals held that the taxpayer was entitled to depletion on the royalty represented by the part of the net profits, holding directly contrary to the Fifth Circuit Court of Appeals in the present case. The Circuit Court of Appeals in the *Crawford* case specifically refused to agree with the Fifth Circuit Court of Appeals in the *Kirby Petroleum Company* case.

In view of this additional conflict between the Fifth Circuit Court of Appeals and the Ninth Circuit Court of Appeals, we respectfully pray that the writ of certiorari in this case be granted.

HOMER L. BRUCE,
Attorney for Petitioner.

IN THE

United States Circuit Court of Appeals

For the
Ninth Circuit

No. 10,885
APRIL 21, 1945

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,
v.
ANNA VICKERS CRAWFORD, *Respondent*.

Upon Petition to Review a Decision of the Tax Court of the United States

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Before: DENMAN, STEPHENS and HEALY, *Circuit Judges*. DENMAN, Circuit Judge:

Petitioner seeks a review of the Tax Court's order holding, that the taxpayer, owner of California oil land, who has made two leases of portions thereof to the Standard Oil Company of California, the lessee to drill for and produce oil therefrom, which leases are terminable by breach of the drilling and other agreements of the lessee, is entitled to depletion deductions for the agreed royalty of a percentage of the net profits of the lessee from its sale of oil extracted from the leased land. The tax years in question are 1938, 1939, and 1940.

The Tax Court relied, in part, upon our decision in *Commissioner v. Felix Oil Co.*, F.2d 276, in which we decided that such a lessor is entitled to such deductions for the tax years 1938 and 1939 as a part of the "gross income from property" under § 114 (b) (3) of the Revenue Code. This same section is controlling for the tax year 1940.

Petitioner's brief and argument in the instant case present the same argument, based upon the same authorities, as in the *Felix* case, save that it cites the recent case of *Commissioner v. Kirby Petroleum Co.*, decided by the Fifth Circuit on March 5, 1945, Judge Hutcheson dissenting.

In that case the majority opinion states of such a payment of net profits as here reserved that it "is not the payment in kind of royalty oil or its equivalent" and contends that the net profit from the operation and sale of the oil paid to the owner of the land is not part of the gross income the land owner receives from the property. Unless the majority opinion can be distinguished on the ground that in Texas the title to the oil passes to the lessee,[1] whereas in California[2] it remains in the lessor, we are not in accord with its holding.

The Supreme Court cases relied upon in the *Kirby Petroleum* case are all based on the absence of a prop

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[1] *Theisen v. Robinson*, 117 Texas 489, 510, 8 S.W.2d 646, 651; *Group No. 1 Oil Corp. v. Bass*, 283, U. S. 279, 281.

[2] Under California law the owner of oil land, who leases it for oil production with a royalty interest therein, retains his fee therein. The lease has a profit a prendre in the right to take the oil. If the owner transfers to another his right to collect the royalty, the owner retains the title in the land and the transferee of the royalty has an easement therein. *Callaghan v. Martin*, 3 Cal.2d 110, 123, 124.

erty interest in the oil property at the time the income from its sale is paid. In *Helvering v. O'Donnell,* 303 U. S. 370, as here, "The question is whether respondent [taxpayer] had an interest, that is, a capital investment, in the oil and gas in place." It was held that the taxpayer's prior interest was merely that of a stockholder in the corporation owning the oil land and that, as stockholder, he did not have any capital interest in the corporation's property. Hence he was not entitled to depletion on the "one-third of the net profits derived from the development and operation of the properties."

In *Helvering v. Elbe Oil Land Development Co.,* 303 U. S. 372, the taxpayer had conveyed all his interest in the oil land. Relying upon the *O'Donnell* case, the Supreme Court held that the net profits from the operation agreed to be paid *after* title had passed from the taxpayer were not subject to depletion.

In these two cases all the Supreme Court's discussion of capital interest in the oil becomes meaningless if a royalty is not subject to depletion if payable in "net profits" of the operation. Cf. dissent Judge Hutcheson in *Kirby* case.

The Kirby majority opinion does not question that if the royalty there had been a fraction of the *gross* cash proceeds received by the lessee from the sale of the oil taken from the land, it would be subject to depletion as "gross income from the property" to the taxpayer. *Cf. Thomas v. Perkins,* 301 U. S. 655; *Anderson v. Helvering,* 310 U. S. 404, 407, 410. We are

unable to see that it is any less "gross income" *to the taxpayer* from his interest in the fee in the property because the lessee deducts its costs of production before paying the taxpayer. That it is net proceeds to the lessee does not make it any the less the gross income from the land to the owner of the fee. Cf. dissent of Judge Hutcheson.

The majority opinion in the *Kirby case* seems to regard as a reason the net income from the oil is to be deemed not within the depletion provision, that it requires more calculation than the determination of the sales price of the oil produced from the taxpayer's fee. We can see no reason why the calculations necessary in all other net profit income returned during the taxable year makes the royalty paid the taxpayer any the less part of the gross income to the taxpayer from the fee owned by him. We see nothing in *Commissioner v. Kirby* or the argument here to require an overruling of our decision in *Commissioner v. Felix Oil Co.,* supra.

The order of the Tax Court is Affirmed.

(Endorsed:) Opinion. Filed April 21, 1945. PAUL P. O'BRIEN, *Clerk.*

No. 56

In the

Supreme Court of the United States

October Term, 1945

KIRBY PETROLEUM COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR PETITIONER

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Attorney for Petitioner

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BRIEF FOR PETITIONER

I.

The Opinions of the Courts Below

The opinion of the Tax Court (R. 10) is reported in 2 T. C. 1258, and that of the Circuit Court of Appeals (R. 38) in 148 F. 2d 80.

II.

Jurisdiction.

Jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

The judgment of the Circuit Court of Appeals was entered March 5, 1945. (R. 50.)

III.

Statement of the Case.

This cause was tried before the Tax Court on the pleadings (R. 2-10) and stipulation. (R. 22-36.)

Petitioner owned the *fee title* to a tract of land except that there was outstanding a 1/8 interest in the minerals. On September 29, 1927, it executed a regular oil and gas mineral lease (R. 24-29) upon the property reserving a royalty of 1/6 on oil and in substance 1/6 on the amount realized from the sale of gas. Out of its 1/6 royalty it absorbed the outstanding 1/8 interest so that its gross royalty was a net 1/24 [R. 4, par. (A) (6)]. On the same day it executed an agreement (R. 29-36) with the lessees, which recited the execution of the lease and provided that the lessees should also pay petitioner 20% of the net profits derived by the lessees from their operations under the lease and then provided in detail for the accounting procedure in the determination of the net profits. Both the lease and the agreement were executed by George Sawtelle, a Vice-President of petitioner. It was stipulated (R. 23-24) that he, if sworn, would testify that petitioner would not have executed the lease unless the lessees had also executed the contemporaneous agreement as a part of the consideration for petitioner's executing the lease, that the lessees did execute the agreement as a part of the consideration for petitioner's executing the lease, and that petitioner also received a cash bonus from the lessees for executing the lease. This testimony was uncontradicted.

Production was obtained in 1932, and in 1935 peti-

tioner received its first payment under its net profits agreement, and received such payments of profits for each year through 1940, the year involved. For 1940 its part of the net profits was $26,223.70, and in its income tax return for that year it deducted as depletion 27½% of this amount. The Commissioner disallowed this depletion deduction (R. 23, Par. 5). The Commissioner did not question its deduction for depletion on its 1/24 royalty.

Petitioner appealed to the Tax Court on this one point. The Tax Court in its opinion and decision (R. 10-17) held that petitioner was entitled to the depletion allowance, and held that in granting the lease the petitioner retained for itself the 1/6 oil royalty and 20% net profits from the operation of the lease each year. The Circuit Court of Appeals reversed the judgment of the Tax Court and apparently held that, although petitioner retained an economic interest in the oil and gas in place to the extent of the cash bonus and the 1/6 royalty, it nevertheless surrendered all of its other interest and retained no economic interest in the oil and gas in place by virtue of which it received 20% of the net profits but received this 20% merely as a result of its having a chose in action or economic advantage (R. 38, 40).

Judge Hutcheson filed a dissenting opinion (R. 44), holding that petitioner was entitled to the depletion allowance on the net profits to the same extent as it was on the 1/24 royalty and that the Tax Court should be affirmed.

In point A of our brief in support of our petition

for a writ of certiorari we raised the point as to whether the Circuit Court of Appeals was authorized to treat the lease and net profits agreement as two separate transactions when the Tax Court had treated them as one. The respondent in his Memorandum filed in connection with our petition stated on page 7:

> "Particularly, there is no warrant for the assertion (Pet. 4, 5, Br. 14-15) that the Circuit Court of Appeals treated the contemporaneous agreements as separate transactions while the Tax Court had determined that they were part of one transaction. Nothing in the opinion of the Circuit Court of Appeals suggests that it considered that, because the agreement to pay 20 percent of the net profits to the lessor was embodied in a separate document, it should be treated as a separate transaction or that it would have reached a different result if that agreement had been embodied in the lease. Both the Tax Court and the Circuit Court of Appeals arrived at their respecive conclusions without attaching any significance to the fact that there were two documents rather than a single one."

In view of this statement by respondent both parties are in accord that this transaction may be treated as if petitioner simply executed an oil and gas lease on its fee property and retained a royalty of 1/6 of the gross oil and gas and 1/5 or 20% of the net profits.

IV.

Questions Presented.

1. Whether the Circuit Court of Appeals had authority to make findings of fact and inferences of

fact contrary to those of the Tax Court and thereby hold that petitioner was not entitled to the depletion claimed.

2. Whether petitioner is entitled to the depletion allowance of 27½% upon the amount received by it under the 20% net profits provision.

V.

Statutes Involved.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvments, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *
(26 U. S. C. 1940 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b)—*Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under Section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 1940 ed., Sec. 114.)

VI.

Specification of Errors.

1. The Circuit Court of Appeals erred in substituting its findings of fact and inferences of fact contrary to those of the Tax Court and in thereby holding that petitioner was not entitled to depletion on the proceeds of the 20% net profits.

2. The Circuit Court of Appeals erred in holding that petitioner was not entitled to the depletion allowance on the amount received by it under the provision of its contract that it was to receive 20% of the net profits from the operation of the properties.

ARGUMENT.

Summary of the Argument.

Point A.

The Circuit Court of Appeals had no authority to make findings of fact and inferences of fact contrary to those of the Tax Court and thereby hold petitioner was not entitled to the depletion claimed.

Point B.

Petitioner at all times had an economic interest in the oil and gas produced and was entitled to the depletion allowance on the amount received by it under the 20% of net profits provision.

Point A.

The Tax Court in its opinion, after setting out the facts, summarized the contentions and distinctions made by petitioner (R. 14-15) and concluded in that part of its opinion as follows (R. 14):

> "In the instant case petitioner lays emphasis on the fact that it was the owner in fee simple of two tracts of land and leased them to Humble and to Marland for development and operation and that in granting the lease it retained for itself a 1/6 oil royalty and 20 per cent net profits from the operation of the lease each year. Respondent has not disputed petitioner's right to percentage depletion on the 1/6 oil royalty reserved in the lease but does dispute petitioner's right to percentage depletion on the $26,223.70 net profits which petitioner received in 1940 from operations.
>
> "Petitioner contends that it is as much entitled to depletion on this $26,223.70 as it is on the receipts from its 1/6 oil royalty and distinguishes its situation from that which existed in *Helvering*

v. O'Donnell, supra, and *Helvering v. Elbe Oil Land Development Co., supra,* and *Anderson v. Helvering, supra,* on the grounds which we have already stated. We agree with petitioner in the distinction which it draws."

In discussing what was the gross income under Section 114 (b) (3) of the Internal Revenue Code, the Tax Court said (R. 15):

> "What is petitioner's 'gross income from the property' in 1940 within the meaning of Section 114 (b) (3) and which it must include in its gross income for income tax purposes? We think it is clearly the proceeds from the 1/6 royalty which petitioner retained in the lease and the 20 per cent annual profits which it received from the operation of the lease under the contemporaneous agreement amounting in 1940 to $26,223.70. If this view is correct, then petitioner is entitled to percentage depletion on the amounts received from its part of the profits as much as from the amounts received from its retained 1/6 oil royalty."

Judge Hutcheson in his dissenting opinion agreed with this analysis by the Tax Court, but the majority of the Court held that the lease and contract were entirely different transactions, that the petitioner reserved an economic interest represented by its 1/6 royalty but had no economic interest represented by the 20% of net profits, and for that 20% "accepted the personal covenant of the lessees to pay whatever amount of the net profits became due by the lessees."

We quote the following pertinent parts of the opinion of the Circuit Court of Appeals (R. 40):

"It is immaterial that the transfers here were accomplished by means of a lease; what is material is that the right of the taxpayer to share in the net profits was not derived from the retention of any depletable interest in the oil and gas in place.

"Prior to the execution of the lease and the agreement here involved, the taxpayer (with exception of the 1/8 interest mentioned) had the entire capital investment in the underlying oil and gas. To the extent of the cash bonus and the right to royalty payments, it retained a proportionate economic interest in the oil and gas in place, and to that extent the lessees did not acquire a depletable interest, but to the extent that the taxpayer granted exploration rights and an interest in the minerals in place to producers in exchange for their personal covenant to pay a share of their net profits, there was a conveyance of the taxpayer's interest in a wasting capital asset, and the producers acquired a proportionate depletable interest in the oil and gas conveyed. By surrendering a partial interest in the oil and gas produced from the property, the taxpayer converted a portion of its economic interest into a mere chose in action or economic advantage."

Incidentally, it is impossible to see how the lower court could make this distinction between petitioner's interest in the minerals represented by its royalty measured by gross production and its royalty measured by 20% of the net profits, when the entire fee title to the minerals would revert to petitioner upon abandonment, surrender or forfeiture of the lease by the lessee. In any such latter event the lessee would retain no interest in the minerals represented by the 20% of net profits provision.

This Court in *Dobson v. Commissioner,* 320 U. S. 489, held that a determination of the Tax Court as to whether particular transactions are integrated or separated for tax purposes is no more reviewable than any other question of fact. Here the Tax Court held that the lease and contract were for tax purposes all one transaction and agreed with petitioner's contention "that in granting the lease it (petitioner) retained for itself a 1/6 oil royalty and 20 per cent net profits from the operation of the lease each year" and that petitioner's gross income for depletion purposes was the 1/6 royalty and the 20% profits. These findings and the other findings were binding upon the Circuit Court of Appeals under the decisions of this Court in *Dobson v. Commissioner, supra, Wilmington Trust Company v. Helvering,* 316 U. S. 164, and *Choate v. Commissioner of Internal Revenue,* 324 U. S. 1. Such a rule is particularly salutary in a case like this in the interest of uniformity in applying the tax law. We refer particularly to the discussion on this in the footnote at pages 499-500 of 320 U. S. in this Court's opinion in *Dobson v. Commissioner.* As far back as 1932 the Board of Tax Appeals held[1] that where a landowner leased his land and obtained a royalty of a certain per cent of the net profits, he was entitled to depletion thereon. The Commissioner acquiesced in that case in 1933[2] and did not contend to the contrary until 1942 in the *Felix Oil Com-*

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[1] *Green v. Commissioner,* 26 B. T. A. 1017

[2] XII-1 C. B. 6.

pany case[3]. Both the Board of Tax Appeals and the Ninth Circuit held again that the landowner was entitled to depletion on the net profits reservation. The Tax Court in the present case made the same findings and for the sake of uniformity in the administration of the taxing statutes, the Circuit Court of Appeals under the authorities of this Court above referred to should not have substituted its own findings and inferences of fact for those of the Tax Court.

Since our petition for a writ of certiorari was filed this Court has handed down its opinion in *Bingham's Trust v. Commissioner of Internal Revenue*, 65 S. Ct. 1232. Frankly we are uncertain as to whether under the *Bingham* case the Circuit Court of Appeals was authorized or not to reverse the Tax Court. It would seem to us, however, that the Tax Court's findings that the two instruments were all one transaction is clearly conclusive. It would seem to us that the Tax Court's finding that petitioner received money under the 20% net profits provision because of its ownership of the oil and gas is likewise conclusive, and that the Circuit Court of Appeals had no authority to substitute a contrary finding that petitioner received that money merely by reason of "the personal covenant of the lessees to pay whatever amount of net profits became due by the lessees". (R. 43.) Nor do we

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[3]*Memorandum Decision by the Tax Court of December* 18, 1942, *not published in the regular reports but found as C. C. H. Decision* 12,920-*A of Commerce Clearing House, Inc.: Tax Court Service, and affirmed by the Ninth Circuit Court of Appeals in* 144 F. 2d 276 *from which the Commissioner took no appeal.*

see how the Circuit Court of Appeals had authority to find that petitioner retained no economic interest in the minerals in so far as the 20% was concerned when the Tax Court found that it did retain such interest.

Point B.

Petitioner Entitled to Depletion.

The majority opinion of the Circuit Court of Appeals confused the test of petitioner's right to depletion with the method of measuring its gross income upon which its depletion is to be computed and came to its erroneous conclusions, as was so forcefully and clearly pointed out by Judge Hutcheson in his dissenting opinion. The question is simple and also simple of solution if, as Judge Hutcheson said, we do not blindly point "with unwavering finger at the words 'net profits'" and then unreasoningly say "No" to petitioner.

Boiled down to its barebones facts, it is the same as if petitioner, the fee owner of the land, had executed an ordinary oil and gas lease and retained therein a royalty of 1/6 of the *gross* income from the minerals and 1/5 of the *net* income therefrom. Section 114(b) (3) provides that

> "the allowance (to petitioner) for depletion under Section 23(m) shall be 27½ per centum of the *gross income* (of petitioner) from the property during the taxable year".

This section is concerned with the *amount* of petitioner's gross income from the property and not with the formulas, methods, measures or standards that are

to be applied by the lessee and lessor in determining the amount to be paid petitioner by the lessee. Once the amount of the gross income of petitioner is determined by whatever method, the statute allows it a depletion deduction of 27½% of that amount, whether that amount is a percentage of the gross production of the minerals or the gross production less production expenses. The confusion of the Circuit Court of Appeals is illustrated by the following extract from the opinion of the majority (R. 41):

> "A taxpayer who leases solely for net profits no longer has a direct interest in the production of mineral deposits; his interest is in the ability of the operators to earn profits. It is true that there would be no net profits if there were no production; but since production could take place without there being any net profits, the taxpayer's income accrues after, not at the time of, the extraction of the oil and gas from the deposits."

The Circuit Court of Appeals apparently would read into Section 114(b) (3) a qualification so that section would provide as follows, the part in italics corresponding to the qualification of the Circuit Court of Appeals:

> "In the case of oil and gas wells the allowance for depletion under Section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, *provided such gross income is measured by a fractional part of the total gross income from the property.*"

There is no such qualification in the statute, and this Court in the *Mountain Producers Corporation*

case[4] has stated that the term "gross income from the property" means gross income from oil or gas and the term must be taken in its natural sense. This Court has said that this gross income is to be the measure of the base for depletion without regard to the particular kind of contract under which this gross income is determined as between the lessor and the lessee. This Court in that case, after pointing out that Congress had adopted percentage depletion to avoid complexities in determining cost depletion, said on page 382:

> "The rule being of this sort for obvious purposes of administrative convenience, we must apply it in the simple manner it contemplates. The 27½ per cent. allowed is a fixed factor, not to be increased or lessened by asserted equities. The term 'gross income from the property' means gross income from the oil and gas (Helvering v. Twin Bell Syndicate, supra) and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned. If, in this instance, the development operations had failed to produce oil, it would hardly be said that the expense of drilling, borne under contract by another, constituted 'gross income' of the taxpayer within the meaning of the statute. Nor, when oil or gas is produced, does the statute base the percentage on market value. The gross income from time to time may be more or less than market value *according to the bearing of particular contracts.*"

We may also point out that the company claiming,

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[4]*Helvering v. Mountain Producers Corporation*, 303 U. S. 376, 382.

and being allowed, depletion was entitled only to net profits from the leases involved and was allowed that depletion because its net profits came as income from the oil and gas produced. A company owned certain leases and made a contract with a refinery company to sell to the latter all of the oil produced from these leases, a regular schedule of prices being agreed upon. The contract then provided that the wells should be drilled and the properties operated by the refinery company, which would buy the oil and pay the company owning the leases the schedule of prices agreed upon less the costs of the refinery company in drilling the wells and operating the properties. The owner of the leases contended that it was entitled to percentage depletion upon the cash paid to it by the refinery company and the amount of expenses incurred by the latter in developing and operating the properties, claiming that these two items constituted its gross income. This Court held that it was entitled to depletion only on the cash received and that that was its gross income from the oil and gas in so far as depletion was concerned. In that case Mountain Producers Corporation received 100% of the net profits, and we fail to see why the petitioner in this case should be denied depletion merely because it received only 20% of the net profits.

Petitioner for the year involved received $26,223.70 under the net profits provision (R. 2 (par. A)). Whose income was this, that of petitioner or of the lessee? Petitioner included it in its gross income, and deducted the 27½% depletion of $7,211.52. The

respondent classed it as taxable income of the petitioner, disallowing the depletion deduction. It is therefore clear that it was income of the petitioner. It was not even included by the respondent in the taxable income of the lessee. The respondent treated it as ordinary income. The $26,223.70 was not received by the petitioner as the proceeds of a sale of any interest in the property. If it were, then petitioner would have been entitled to deduct the cost of the interest in the property sold by it, which deduction it of course did not take. Likewise, if it were received by petitioner as part of the proceeds of the sale of an interest in the property, the same amount would be taxable to the lessee[5], but the respondent did not class it as taxable income of the lessee. Therefore, it was income of petitioner, and it was income as the result of production of oil and gas from petitioner's property, and it necessarily follows that it was "gross income from the property" of petitioner upon which the 27½%. depletion was to be computed.

The purpose of the depletion allowance is to allow an owner of an interest in the minerals to recover his cost thereof through his income from the minerals. In this case petitioner leased the land for a fractional royalty measured by gross production and a fractional royalty measured by net profits. It was all one income to petitioner which it obtained because it owned the minerals and was willing to execute a lease on these terms. In view of the record and of the findings of the Tax Court, the lease and contract were all one transac-

[5] *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372.

tion and are to be treated as if they were one instrument reserving a royalty of 1/6 of the gross and 20% of the net profits. We refer to the analysis of the contract set forth in footnote 4 of Judge Hutcheson's opinion, where he shows that under clause IV of the contract the lessor and lessee were both interested in all oil to be marketed from the premises and that this was not a mere personal obligation on the part of the first lessees but was a contract that was binding upon their successors in interest in the lease.

The opinion of the Circuit Court of Appeals says that the present case cannot be distinguished from the *O'Donnell, Anderson* and *Elbe Oil Company* cases[6]. We will refer to them later in this brief.

This Court in every case has held that, where a party owned an economic interest in the oil and gas as distinguished from merely an economic advantage through a contract, he was entitled to the depletion allowance through which to recover his capital investment, and the test laid down by this Court is whether such a party does have an economic interest in the minerals.

In two of the earlier cases[7], this Court held that a landowner upon executing a lease was entitled to depletion upon both the bonus and the royalties as a

[6]*Helvering v. O'Donnell,* 303 U. S. 370; *Anderson v. Helvering,* 310 *U. S.* 404; *Helvering v. Elbe Oil Land Development Company,* 303 *U. S.* 372.

[7]*Burnet v. Harmel,* 287 U. S. 103; *Murphy Oil Company v. Burnet,* 287 *U. S.* 299.

source from which to recover his capital investment in the minerals.

In the next case[8] this Court had before it the question of whether a lessee, who upon assigning a lease received a cash bonus and retained an oil payment and an overriding royalty, was entitled to depletion on these items. This Court first referred to the nature of the lessor's right to depletion, saying on page 557:

> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. See Burnet v. Harmel, supra; Bankers Pocahontas Coal Co. v. Burnet, ante, p. 308."

It then referred to the specific case before it and, in holding the lessee-assignor entitled to depletion, said on page 558:

> "Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its

[8] *Palmer v. Bender*, 287 *U. S.* 551.

depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to 'the peculiar conditions in each case.''

The *Bankline Oil Company* case[9] is not even comparable to the present one. The taxpayer operated a casinghead gasoline plant for the extraction of gasoline from wet gas, and the only connection that it had with any production was that it had two types of contracts with producers of gas, under one of which the gas was delivered to the taxpayer who extracted the gasoline and agreed to pay the producer 1/3 of the gross proceeds from the sale of the gasoline or to deliver to him 1/3 of the gasoline, and under the other the taxpayer purchased outright from the producer all the natural gas and agreed to pay the producer 1/3 of the gross proceeds received from the sale of the extracted gasoline. There the taxpayer never had any remote interest in the minerals in place.

The *O'Donnell* case[10] was the first so-called net profits case decided by this Court. The taxpayer there never had any interest at any time in the oil and gas. He merely owned part of the stock of the

[9] *Helvering v. Bankline Oil Company*, 303 *U. S.* 362.

[10] *Helvering v. O'Donnell*, 303 *U. S.* 370.

San Gabriel Petroleum Company, which he sold to Petroleum Midway Company, Ltd., and, as consideration for the payment for the stock, the Midway Company agreed to acquire the properties of the San Gabriel Company and pay the taxpayer 1/3 of the net profits from the operation of those properties. That is a far cry from the present case where petitioner was the land owner and in substance made a lease retaining a royalty measured by the gross production and another royalty measured by the net profits.

In the next so-called "net profits case"[11], which the lower court says cannot be distinguished from the present case, taxpayer did own an interest in certain oil and gas properties, but it made an absolute sale of all of its interest in those properties for $350,000 cash, $1,650,000 additional cash payable over a period of four years, and for the additional agreement by the purchaser to pay taxpayer 1/3 of the net profits resulting from the operation of the properties after the purchaser had recovered all its expenditures in the acquisition, development and operation of the properties. As pointed out by this Court on page 374, the agreement specifically provided that:

> "It is the intention of the parties to this agreement that the full ownership, possession and control of all the properties * * * shall be vested in Honolulu (purchaser) and Elbe shall have no interest in or to said properties * * * ."

This Court simply held that, after the execution of such contract, the taxpayer had no further interest

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[11] *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372.

in the properties and received its net profits as part of the consideration for a sale of its interest.

In the third case that the lower court says cannot be distinguished[12] the owner of certain royalty interests, fee interests and deferred oil payments, sold the same to a purchaser for $50,000 cash and $110,000 to be paid from one-half the proceeds received by the purchaser from oil and gas produced from the properties and from the sale of the lands owned in fee, the seller retaining a lien upon all of the properties. The question involved was whether the *purchaser* should be required to include in his income the entire proceeds received from the oil and gas produced although one-half was paid to the seller. This Court held that this was a completed sale of the properties, that the purchaser obtained the entire interest and that the payments to the seller were merely by way of purchase price. We cannot see the applicability of that case to the present one.

One last case[13] will be referred to. Taxpayer owned certain leases and made a contract with an oil company under which the oil company was granted the right to go upon the leased properties, drill wells thereon and produce all the oil and gas therefrom at its own expense. The contract then provided that all the oil and gas should be delivered to the taxpayer, who would sell the same and pay the oil company two-thirds of the net proceeds, with the provision that if the lessor took its royalty of 5% in oil, the taxpayer would pay the oil company 66 2/3% of the net pro-

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[12] *Anderson v. Helvering*, 310 *U. S.* 404.

[13] *Spalding v. U. S.*, 97 *F. 2d* 697.

ceeds. In that case the taxpayer was actually obtaining one-third of the net proceeds from the operation of the property with all operations and expenses being borne by the oil company. The taxpayer claimed the right to take depletion on the entire production instead of on one-third. The Government did not even contest the right to take depletion on the one-third but denied the depletion on the two-thirds because the oil company was the one entitled to depletion on that part, and the court sustained the position of the Government. It will be noted in that case that the taxpayer was allowed the depletion on the one-third interest owned by taxpayer.

In this case respondent owned the minerals in fee and at all times came more clearly within the economic interest test laid down by this Court than many taxpayers who have been allowed by this Court to take depletion. Petitioner was willing to make a lease but wanted to recover its capital investment in the property through a participation in the returns from the production of the depletable minerals. This took the form of a cash payment, a retained royalty and a participation in the net profits. The provision concerning net profits was merely a method of determining the part of the minerals or their proceeds that should be paid to the petitioner as the owner of the minerals in fee. In the preambles to the supplementary agreement, after a reference to the lease, it is recited:

> "The parties to said lease have agreed that Second Party shall be entitled to receive twenty per cent (20%) of the net money profits derived

by First Party from operations under said lease, said twenty per cent (20%) net money profits interest being specifically described and defined and payable as is hereinafter provided." (R. 30.)

Paragraph I of the contract then provided:

"Second Party, subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty per cent (20%) of the net money profits realized by First Party from its operations under and by virtue of the lease referred to above. The net money profits in which Second Party shall participate under the terms hereof, shall be calculated and determined and be payable as hereinafter provided." (R. 30.)

Paragraph IV provided:

"First Party (lessee) shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, *and in which the parties hereto may be interested.* Upon the sale of any of such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales * * * ." (R. 32.)

Paragraph V provided:

"Second Party (petitioner) shall participate in the profits *derived from the sale of the oil and gas and other mineral production of the lease* embraced in this agreement only after all charges and debits and costs of producing profits shall have been paid and provided for. * * * ." (R. 33.)

Paragraph IX provided:

"This contract shall be binding upon the parties hereto and their respective successors in interest." (R. 34.)

This contract shows in detail that the amount received by petitioner under the 20% provision was directly out of income from the oil and gas produced from the property owned by petitioner in fee, even if this were not self-apparent otherwise, and petitioner's right to that income arose from its interest in the oil itself and not by virtue of a mere personal covenant of the lessee. We respectfully refer to Judge Hutcheson's detailed analysis of the contract. (R. 45-48.)

This contract and the lease merely provided for the total return by way of income from the production of petitioner's minerals that petitioner was to receive. It received this total amount because of its fee ownership of the minerals. Certainly, no one can have a greater economic interest in minerals than the fee owner thereof, and it is respectfully submitted that petitioner under every test laid down by the courts is entitled to the 27½% depletion upon the amounts received by it under the 20% net profits agreement.

We refer briefly to the statement of the court below that, if depletion were allowed on the net profits, the depletion could not be ascertained until the amount of net income is determined and that "This poses an abstruse problem instead of the rule of thumb that the arbitrary percentage-depletion allowance was intended to be." We see no abstruse problem involved. The statute says that petitioner will be allowed a depletion of 27½% of its gross income. We see no difficulty in computing the 27½% allowance upon the income that was received by petitioner from the 20% provision. The amount received in the year in-

volved was $26,223.70, and 27½% of that was $7,-211.52. (R. 23.) Judge Hutcheson in his dissenting opinion found no difficulty in determining petitioner's allowance on this basis, saying "the 20 percent payment it received constituted, under *Helvering v. Producers,* 303 U. S. 382, the 'gross income' on which its depletion must be taken." We see no obstruse problems or involved administrative difficulties that might arise.

Every court that has passed upon a similar net profits provision has held that the income therefrom was subject to depletion. The Board of Tax Appeals as early as 1932[14] had an exactly similar case and allowed the depletion claimed. The Commissioner in 1933[15] acquiesced in that case, and did not withdraw that acquiescence until 1942[16] after the present case arose in the Bureau of Internal Revenue. In 1944 the Ninth Circuit Court of Appeals[17] affirmed the Tax Court in allowing the landowner depletion where the royalty reserved by it in its lease consisted solely of 50% of the net profits of the lessee. In that case if the landowner had been denied depletion, it never could have recovered any part of its cost of the minerals as the royalty retained by it was measured entirely by net profits. In a later similar case[18] the Ninth Circuit Court of Appeals had a net profits case similar to that of the *Felix Oil Company* and the present one of this

[14] *W. S. Green v. Commissioner,* 26 B. T. A. 1017.

[15] *XII*-1 C. B. 6.

[16] 1942-1 C. B. 23.

[17] *Commissioner v. Felix Oil Company,* 144 F.2d 276.

[18] *Commissioner of Internal Revenue v. Crawford,* 148 F.2d 776.

petitioner, and allowed the depletion claimed, affirming the Tax Court, following its holding in the *Felix Oil Company* case, and refusing to follow, and criticising, the opinion of the Circuit Court of Appeals in this case. See also *Commissioner of Internal Revenue v. Caldwell Oil Corporation,* 141 F.2d 559 (Fifth Circuit Court of Appeals); *Marrs McLean,* 41 *B.T.A.* 565, 574 (depletion allowed on percentage of net profits received under the Gray leases, affirmed on other issues, *McLean v. Commissioner of Internal* Revenue, 120 F.2d 942).

The action of the Circuit Court of Appeals in this case will in itself, if not reversed, cause great confusion in the oil industry, and is an unrealistic approach to the question. It seems to be of the opinion that gross income on which a landowner is entitled to depletion must be by way of a royalty represented by a fraction of the gross production. In the early stages of oil development practically the only kind of royalty reserved by a landowner in a lease was 1/8 of the gross production. However, this is no longer the situation, and landowners, when they execute a lease, are having many different kinds of royalties reserved, each one depending upon the kind of trade the landowner can make with the lessee. Summers[19] sets out the many forms of oil, gas and mineral leases currently used. Royalty on gas is never 1/8 of the gas but is always 1/8 of the proceeds of the gas, or some other fraction[20]. Royalty on sulphur is never measured by a fraction of the gross production or the gross value but

[19] *Summers, Oil & Gas,* 1939 Edition, Vol. 7.

[20] *Summers,* Vol. 7, pages 266, 270, 274, 280, 290, 294.

is always a fixed number of cents per ton[21]. With the development of processes for extracting gasoline from gas, whether from gas wells or casinghead gas from oil wells, a further source of profit was developed, but owing to the complicated arrangements necessary for running such gas through extraction plants, no simple royalty measured by gross was workable and the income of the landowner from the gasoline extracted and the residue gas is generally measured by a portion of the net profits from such operation or a price per gallon of gasoline obtained, depending upon sliding schedules. Likewise landowners have become more insistent upon having, in addition to an assured return measured by gross production, an additional opportunity to share in the net profits, just as was done by Felix Oil Company and petitioner in this case.

In rejecting petitioner's claim the majority opinion of the court below said in part (R. 43):

> "If net profits, which cannot be computed or paid until they are earned, are rents and royalties within the meaning of Section 114(b) (3), the depletion allowances on the working interest cannot be ascertained until the amount of net income is determined. This poses an abstruse problem instead of the rule of thumb that the arbitrary percentage-depletion allowance was intended to be."

We respectfully submit that there is no such abstruse problem posed. It is a simple matter to examine the books of petitioner, or of any landowner having any of the varied types of arrangements with his lessee

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[21] *Summers*, pages 266, 271, 275, 280, 291, 295.

above outlined, to determine how much money he has received from his lessee during the year as income under his contract with his lessee, and the allowable depletion is simply $27\frac{1}{2}\%$ of this amount. On the other hand, if the decision of the lower court is affirmed in this case, it would seem to us to follow that all of the varied deals made between landowners and their lessees will be thrown into confusion and there will then follow real abstruse legal problems to determine which landowner is entitled to depletion and which one is not. This Court has already solved these abstruse legal problems when it said in the *Mountain Producers Corporation* case, [22] supra,

> "The term 'gross income from the property' means gross income from the oil and gas (Helvering v. Twin Bell Syndicate, supra) and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned * * * *. The gross income from time to time may be more or less than market value *according to the bearing of particular contracts.*"

Conclusion.

It is respectfully submitted that the judgment of the Fifth Circuit Court of Appeals should be reversed and that of the Tax Court of the United States should be affirmed.

HOMER L. BRUCE,
Attorney for Petitioner

[22] *Helvering v. Mountain Producers Corporation,* 303 U. S. 376, 382.

No. 1139 56

In the Supreme Court of the United States

OCTOBER TERM, 1944

KIRBY PETROLEUM COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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v.

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MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 16–22) is reported at 2 T. C. 1258; that of the Circuit Court of Appeals (R. 54–59) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 5, 1945. (R. 66.) The petition for a writ of certiorari was filed on April 9, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer was the owner of the fee simple title to two tracts of land. As to one tract, however, there was an outstanding one-eighth mineral interest. The properties were leased for oil and gas exploration and production, the taxpayer retaining a royalty of one-sixth of all oil produced and saved and being entitled to varying royalties on other minerals. By a separate, contemporaneous agreement, which formed part of the consideration for the lease, the taxpayer became entitled to twenty percent of the net profits earned by the lessees as a result of their operations.

The question is whether the Circuit Court of Appeals erred in holding that the taxpayer was not entitled, under Sections 23 (m) and 114 (b) (3) of the Internal Revenue Code, to a deduction for depletion on its share of the lessees' net profits.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra.*

STATEMENT

The facts in this case were stipulated by the parties (R. 32-48), and were found by the Tax Court as stipulated (R. 17).

Taxpayer owned the fee simple title to two tracts of land except that, as to one tract, a one-

eighth mineral interest was outstanding. (R. 17, 33.) On September 29, 1927, taxpayer entered into a lease with the Humble Oil & Refining Company and the Marland Oil Company of Texas, as lessees. (R. 17, 35–39.) Under the lease, which was for the term of five years and as long thereafter as oil or gas should be produced, the lessees acquired the right of "investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals." (R. 35.)

The lease contained provisions for the payment of delay rentals in the event that the lessees had not commenced drilling operations in accordance with the provisions of the lease. (R. 36–37.) There were also provisions for the drilling of further wells in the event that dry holes should be drilled prior to the discovery of oil or gas. Also, in the event that oil was discovered on adjacent property, the lessees were obligated to drill offset wells. (R. 37.)

The lease provided that all obligations of the lessees were to be understood as covenants and not as conditions or limitations, and that the breach thereof "shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby * * *". (R. 38.)

The taxpayer received a cash bonus upon the execution of the lease (R. 34) and was entitled to a royalty of one-sixth of the oil produced and

saved, as well as of one-sixth of the amount realized from the sale of gas (one-sixth of 25 percent of the market value thereof in the event that the lessees manufactured gasoline or other products therefrom) (R. 17, 36). Contemporaneous with the making of the lease, the parties executed an agreement (R. 42–48), which formed a portion of the consideration for the lease. (R. 17–18, 33–34.) Under the terms of the agreement, taxpayer was entitled to 20 percent of the "net money profits" realized by the lessees from their operations under the lease. (R. 18, 43.) The agreement provided how the net profits should be calculated and how taxpayer's share should be paid. (R. 18, 43–45, 46.)

During the year 1940, taxpayer received $26,223.70 as its share of the net profits. In its income tax return for 1940, taxpayer deducted depletion to the extent of 27½ percent of this amount. (R. 18, 33.) The Commissioner's notice of deficiency (R. 9–13) disallowed the depletion deduction on this amount. The taxpayer sought a redetermination of the deficiency before the Tax Court. (R. 4–8.) The Tax Court ruled that the taxpayer was entitled to the depletion deduction (R. 16–22), and entered its decision determining a deficiency in income tax arising out of matters not here in dispute (R. 23). The Circuit Court of Appeals, Judge Hutcheson dissenting, reversed the Tax Court.

ARGUMENT

1. The Government does not oppose the granting of a writ of certiorari in this case. The decision below is in direct conflict with that of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Crawford,* decided April 21, 1945, subsequent to the filing of the petition in this case. In addition, a question of importance in the administration of the revenue laws is presented.

The court below held that the taxpayer no longer had a capital investment in the underlying oil and gas to the extent that it had acquired the right to share in the net profits earned by the lessees. Accordingly, the taxpayer was denied a deduction for depletion on the portion of the net profits received.

The decision below rests upon the proposition of law that the acquisition of a right to share in net profits is not consonant with the retention of a proportionate depletable interest in the minerals not yet produced. This proposition was derived by the court below from rulings of this Court, particularly *Helvering* v. *O'Donnell,* 303 U. S. 370; *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372; and *Anderson* v. *Helvering,* 310 U. S. 404.

The result reached in *Commissioner* v. *Felix Oil Co.,* 144 F. 2d 276 (C. C. A. 9th), would appear to be in conflict with the fundamental theory on which the present case was decided. However, it may be noted that the decision in the *Felix* case

appears to rest, not on the "practical consequences of the provision for payments",[1] but rather on certain other provisions of the instrument. Because of the uncertainty as to the scope of the *Felix* decision the Commissioner requested the Circuit Court of Appeals for the Ninth Circuit, in *Commissioner* v. *Crawford, supra,* to reconsider its position. In the *Crawford* case, as here, the lessor received a cash bonus and was entitled to oil royalties and, in addition, to a share of the lessees' net profits.

The decision in the *Crawford* case, without referring to or resting on any peculiar provisions of the leasing agreements, concluded that the taxpayer's share of the net profits was her "gross income from the property" on which depletion was to be allowed. While we believe the *Crawford* decision to be erroneous, we recognize that it is in conflict with the decision in the case at bar.

2. In addition to relying upon the asserted conflict between the decision below and that in *Commissioner* v. *Felix Oil Co., supra,* the petitioner contends that the Circuit Court of Appeals in this case disregarded findings of fact made by the Tax Court. (Pet. 4–5, Br. 11, 12–15.) We believe that this contention rests upon a misconception of the decision below.

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[1] *Anderson* v. *Helvering*, 310 U. S. 404, 411.

The facts in this case were stipulated (R. 32–48) and were found by the Tax Court as stipulated (R. 17). The opinion of the Circuit Court of Appeals in no way shows any departure from the facts as found by the Tax Court. Particularly, there is no warrant for the assertion (Pet. 4, 5, Br. 14–15) that the Circuit Court of Appeals treated the contemporaneous agreements as separate transactions while the Tax Court had determined that they were part of one transaction. Nothing in the opinion of the Circuit Court of Appeals suggests that it considered that, because the agreement to pay 20 percent of the net profits to the lessor was embodied in a separate document, it should be treated as a separate transaction or that it would have reached a different result if that agreement had been embodied in the lease. Both the Tax Court and the Circuit Court of Appeals arrived at their respective conclusions without attaching any significance to the fact that there were two documents rather than a single one.

The Circuit Court of Appeals did not differ with the Tax Court on what the facts were, or on what proper factual inferences should be drawn, or on whether the transaction was to be viewed as an integrated one. The disagreement was only on a question of law, namely, the implications properly to be drawn from the decisions of this

Court. Upon an analysis of those decisions, the Circuit Court of Appeals concluded that the taxpayer retained a proportionate depletable interest to the extent that it received a cash bonus and was entitled to royalty payments. To the extent, however, that the taxpayer granted exploitation rights to the lessees in exchange for a share of their net profits, it was ruled that the lessees, not the lessor, must have the depletable interest.

CONCLUSION

We believe that the decision of the court below is correct. Since the decision in this case is in conflict with that of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Crawford, supra,* and since the Commissioner of Internal Revenue advises that a question of large importance in the administration of the revenue laws is presented, we do not oppose the granting of the petition for a writ of certiorari in this case.

Respectfully submitted.

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Special Assistants to the Attorney General.

MAY 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument

creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

(26 U. S. C., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C., Sec. 114.)

Treasury Regulation 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (m)–1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for de-

preciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

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No. 56

In the Supreme Court of the United States

October Term, 1945

Kirby Petroleum Company, petitioner
v.
Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 10–17) is reported at 2 T. C. 1258. The opinion of the Circuit Court of Appeals (R. 38–43) and the dissenting opinion in that court (R. 44–50) are reported at 148 F. 2d 80.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 5, 1945 (R. 50). The petition for a writ of certiorari was filed on April 9, 1945, and was granted on May 21, 1945 (R. 51). The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer was the owner of the fee simple title to two tracts of land. As to one tract, however, there was an outstanding one-eighth mineral interest. The properties were leased for oil and gas exploration and production, the taxpayer retaining a royalty of one-sixth of all oil produced and saved and varying royalties on other minerals. By a separate, contemporaneous agreement, which formed part of the consideration for the lease, the taxpayer became entitled to 20 percent of the net profits earned by the lessees as a result of their operations.

The question is whether the Circuit Court of Appeals erred in holding that the taxpayer was not entitled, under Sections 23 (m) and 114 (b) (3) of the Internal Revenue Code, to a deduction for depletion on its share of the lessees' net profits.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 43–47.

STATEMENT

The facts in this case were stipulated by the parties (R. 22–36), and were found by the Tax Court as stipulated (R. 11).

Taxpayer owned the fee simple title to two tracts of land except that, as to one tract, a one-eighth mineral interest was outstanding (R. 12,

23). On September 29, 1927, taxpayer entered into a lease with the Humble Oil & Refining Company and the Marland Oil Company of Texas, as lessees (R. 12, 22). Under the lease, which was for the term of five years and as long thereafter as oil or gas should be produced, the lessees acquired the right of "investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals" (R. 24).

The lease contained provisions for the payment of delay rentals in the event that the lessees had not commenced drilling operations in accordance with the provisions of the lease (R. 25–26). There were also provisions for the drilling of further wells in the event that dry holes should be drilled prior to the discovery of oil or gas. Also, in the event that oil was discovered on adjacent property, the lessees were obligated to drill offset wells (R. 26–27).

The lease provided that all obligations of the lessees were to be understood as covenants and not as conditions or limitations, and that the breach thereof "shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby * * *" (R. 27).

The taxpayer received a cash bonus upon the execution of the lease (R. 24) and reserved the right to a royalty of one-sixth of the oil produced and saved, one-sixth of the amount realized from the sale of gas at the wells, the market price of

one-sixth of the gas sold or used off the premises, and, in the event that the lessees manufactured gasoline or other products from the gas, one-sixth of 25 percent of the market value thereof (R. 12, 25). Contemporaneous with the making of the lease, the parties executed an agreement (R. 29–34) as part of the consideration for the lease (R. 12, 24). Under the terms of the agreement, taxpayer was entitled to 20 percent of the "net money profits" realized by the lessees from their operations under the lease (R. 12, 30). The agreement provided a method for the calculation of the net profits and specified the occasions on which taxpayer's share was to be paid (R. 12, 31–33, 34).

During the year 1940, taxpayer received $26,-223.70 as its share of the net profits. In its income tax return for 1940, taxpayer deducted depletion to the extent of 27½ percent of this amount (R. 13, 23). The Commissioner's notice of deficiency disallowed the depletion deduction on this amount (R. 6–9), and the taxpayer sought a redetermination of the deficiency before the Tax Court (R. 2—5). The Tax Court ruled that the taxpayer was entitled to the depletion deduction (R. 11–16), and entered its decision determining a deficiency in income tax arising out of matters not here in dispute (R. 16–17). The Circuit Court of Appeals, Judge Hutcheson dissenting, reversed the Tax Court (R. 50).

SUMMARY OF ARGUMENT

I

The provisions of the statute, the treasury regulations, and the holdings of this Court with respect to the deduction for depletion, point in only one direction, namely, that the single allowance is to be apportioned among the parties in the same proportion as they are entitled to share in the production of the oil and gas, or the gross proceeds derived therefrom. The lessees in this case acquired the right to all the oil in place and its production except to the extent that a bonus was paid and there was an obligation to pay oil royalties. Accordingly, the lessees were entitled to the full amount of the depletion deduction except for the portion representing the share of the oil produced to which others were entitled. The lessor, the taxpayer in the case, was entitled to the deduction for depletion only to the extent that it retained a right to share in the oil produced, evidenced by the cash bonus and the oil royalties received. There being no assurance that production will give rise to net profits, taxpayer's right to receive a share of the lessees' profits is not an interest in the production of oil or in the gross proceeds; taxpayer was not entitled to any depletion on the payments received, and the lessees' right to the deduction could not be defeated to that extent.

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II

The Circuit Court of Appeals did not disregard any findings of fact made by the Tax Court or any inferences that were drawn therefrom. The decision of the Tax Court that under the statute, the regulations, and the decisions of this Court, the taxpayer had a right to depletion on the share of the lessees' net profits which it received, was not in accordance with law and was properly reversed by the Circuit Court of Appeals.

ARGUMENT

I

A LESSOR OF OIL AND GAS PROPERTY WHO IS PAID A SHARE OF THE NET PROFITS EARNED BY THE LESSEE MAY NOT DEDUCT PERCENTAGE DEPLETION ON THE AMOUNTS SO RECEIVED

The taxpayer in this case is the lessor of certain oil producing property. As consideration for the lease, the taxpayer received a cash bonus payment, and became entitled to a one-sixth oil royalty,[1] and, in addition, to one-fifth of the net profits earned by the lessees from their operation of the leased property. The question involved concerns the amount of the percentage depletion deduction which may be taken by the taxpayer

[1] The term "royalty," as used herein, means a fractional portion of the oil and gas produced, or of the gross proceeds from the sale thereof, which is reserved by the lessor. See *Anderson* v. *Helvering*, 310 U. S. 404, 409.

under Section 23 (m) and Section 114 (b) (3) of the Internal Revenue Code (Appendix, *infra*, pp. 43-44). There is no dispute concerning the taxpayer's right to depletion on the cash bonus payment and the oil royalties received. The only issue in this case is whether the taxpayer is also entitled to depletion with respect to the share of the lessees' net profits it received, thereby reducing the amount of the single depletion allowance available to the lessees.

It is the Commissioner's position that under Section 114 (b) (3), construed in conjunction with Section 23 (m) which provides that the depletion allowance shall be equitably apportioned between the lessor and the lessee under rules and regulations promulgated by the Commissioner, and under the decisions of this Court and the applicable treasury regulations, the single depletion allowance can only be apportioned between the lessor and lessee in the same proportion as each is entitled to share in the production of the oil; the single allowance for depletion is subject to apportionment among only those persons who have an interest in the oil and gas which is directly related to the amount of production taking place and which, consequently, suffers physical depletion concurrently and proportionately as production occurs. The single deduction for depletion being shared by such persons in relation to their respective interests in production, all others are necessarily excluded

from participation. The Commissioner further maintains that since the lessor's right to participate in the lessee's net profits is not an interest entitling the lessor to share in the oil produced, no part of the depletion allowance can be taken with respect to the net profits received.

The same basic considerations which establish to whom the gross income from the property is taxable likewise determine who is entitled to the deduction for depletion. "That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest." *Anderson* v. *Helvering,* 310 U. S. 404, 407. The possession of a capital investment in the oil and gas in place is the essential requirement for establishing a depletable interest since the "term 'gross income from the property'" on which the statute[2] permits percentage depletion to be taken "means gross income from the oil and gas." *Helvering* v. *Mountain Producers Corp.,* 303 U. S. 376, 382. This follows from the very nature of the depletion allowance which is granted, as a matter of legislative grace, to compensate for the consumption of capital assets during the process of extracting the mineral deposits. *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362, 366–367. Therefore, if a taxpayer has "no capital investment in the mineral deposit which suf-

[2] Section 114 (b) (3) of the Internal Revenue Code.

fered depletion," he "is not entitled to the statutory allowance." *Helvering* v. *Bankline Oil Co.*, *supra* at p. 368.

If a taxpayer has a capital investment in only a portion of the mineral deposits, he is not entitled to depletion beyond the extent of his interest; he may claim only the allowance with respect to "the gross income from production" which he has "the right to retain." *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 321. See also *Bankers Coal Co.* v. *Burnet*, 287 U. S. 308.

In ascertaining the nature and extent of a taxpayer's capital investment in the oil and gas deposits, legal ownership under state law is not a determinative factor. *Burnet* v. *Harmel*, 287 U. S. 103; *Palmer* v. *Bender*, 287 U. S. 551. Nor is a taxpayer's interest to be determined from the form of the particular instrument involved or from the formalities of the kind of conveyance made; instead, it is the "practical consequences of the provision for payments" which are decisive of this matter. *Anderson* v. *Helvering*, 310 U. S. 404, 411. Accordingly, it is quite immaterial that the taxpayer here possessed the fee ownership of the surface land or might reacquire, because of its reversionary rights, the economic interest in all the underlying minerals upon a forfeiture of the lease. Cf. Pet. Br. 9, 24. Indeed, the owner of land has nothing more than the right to take possession of the oil and gas, and when that right is transferred, as it was

here, it makes no difference whether the transfer is by way of a lease rather than a sale. See 4 Mertens, *Law of Federal Income Taxation* (1942), sec. 24.08, p. 213.

This Court has always held that the provisions for payment (whether acquired or retained) which evidence the existence of a depletable interest are those which arise from a direct interest in the oil which is being produced. Thus, the retention by the lessor of a share of gross production by way of an oil royalty gives the lessor a proportionate depletable interest in the mineral deposits. *Bankers Coal Co.* v. *Burnet*, 287 U. S. 308. The royalties received constitute ordinary income of the lessor from the property and are not considered part of the lessee's income, even though the lessee may have collected the full amount in the first instance before paying the lessor's share to him. *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312; *Palmer* v. *Bender*, 287 U. S. 551. Important here is the fact that the lessor's royalty interest gives rise to taxable income and a depletable interest because it constitutes a share of gross production. As this Court said in *Palmer* v. *Bender*, *supra* (pp. 557, 558):

> It is enough if, by virtue of the leasing transaction, he has retained *a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.*
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> * * * * *

> Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, *were entitled to share in the oil produced.* Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties *according to their respective interests.* [Italics supplied.]

Where the lessor retains the right to share in gross production up to, but not beyond, a stated consideration, by means of an oil payment, such a reservation gives the lessor a proportionate depletable interest in the oil deposits; it constitutes ordinary income to the lessor, and it is not part of the income of the lessee. *Thomas* v. *Perkins,* 301 U. S. 655; *Palmer* v. *Bender,* 287 U. S. 551; *Anderson* v. *Helvering,* 310 U. S. 404, 410–413. In such a situation the provision for an oil payment is "regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments"; accordingly, it is "given the same tax consequences as a provision for oil royalties." *Anderson* v. *Helvering, supra* at p. 411. This, however, is true only where "the reserved payments are to be derived solely from the production of oil and gas" (*Anderson* v. *Helvering, supra* at p. 413), and it will be noted that in the *Anderson* case the Court recognized that in the interests "of a workable rule" the doctrine of

Thomas v. *Perkins, supra,* should not be extended to other situations.

Where the lessor receives a cash bonus and also reserves a continuing interest in gross production, the bonus is considered as the payment of advance royalties and is given the same effect so far as depletion and taxable income are concerned. *Herring* v. *Commissioner,* 293 U. S. 322; *Palmer* v. *Bender,* 287 U. S. 551; *Bankers Coal Co.* v. *Burnet,* 287 U. S. 308; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; *Burnet* v. *Harmel,* 287 U. S. 103; *Commissioner* v. *Clarion Oil Co.,* 148 F. 2d 671 (App. D. C.), certiorari denied, June 18, 1945. The fact that a depletable interest cannot exist unless it has a direct relationship to production is evident from the fact that the depletion taken with respect to a bonus must be restored to income if no production subsequently takes place. *Douglas* v. *Commissioner,* 322 U. S. 275; Section 19.23 (m)–10 (c), Treasury Regulations 103.

The economic interest of each of the parties entitled to participation is his share of the gross production of the oil or the gross income from its sale. This was specifically recognized in *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, where the Court said (p. 321):

> * * * we are unable to say that the Commissioner erred in holding that for the purpose of computation "gross income from the property" *means gross income from production less the amounts which the tax-*

> *payer was obligated to pay as royalties.* The apportionment gives respondent $27\frac{1}{2}$ per cent. of the *gross income from production which it had the right to retain* and the assignor and lessor respectively $27\frac{1}{2}$ per cent. *of the royalties they receive.* Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowance. [Italics supplied.]

It follows that, when the depletion allowance is apportioned in accordance with the respective interests of the parties in the gross production of the oil (or the gross income therefrom), no other interest can be entitled to a deduction for depletion. That is necessarily so since no other interest is derived from the gross income obtained from the production and sale of the oil.

Thus, where the lessor of oil and gas properties receives an advance on production in the form of a cash bonus and a fractional portion of production, in the form of an oil royalty, and also a fractional portion of production until a certain sum has been received, in the form of oil payments, those items constitute the "gross income from the property" which is taxable to the lessor and with respect to which he is entitled to a deduction for depletion. All the remainder of the gross production is attributable to the lessee; the proceeds from that amount of the oil constitute his gross income, and are "the gross income from the prop-

erty" with respect to which he is entitled to depletion.

Where the lessor, in addition to a bonus, oil royalties, and oil payments, is entitled to receive a portion of the net profits earned by the lessee from his operations, the net profits received cannot represent the return on a capital investment which is depletable. As analyzed above, when the lessor receives depletion on the share of gross production which he has reserved, the lessee must be entitled to depletion on all the remaining gross production since the gross proceeds from that production arise from his share of the oil and are attributable to him and to him alone.

The principle that an interest in net profits cannot constitute a depletable interest follows not only from the above-cited cases, but has been specifically applied by this Court. Thus, in *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372, the taxpayer, the owner of certain oil property, had transferred it for a stated consideration, part of it payable at the time of the execution of the agreement, and additional amounts payable in succeeding years if the transferee should elect not to abandon the transaction. The taxpayer, in addition, was entitled to receive one-third of the net profits which the transferee might earn after having been fully reimbursed for its expenditures in the acquisition, development, and operation of the properties. It was held that the taxpayer was not to be permitted a deduction for depletion on

the cash payments received, it being decided that no interest was retained by the taxpayer in the oil and gas in place and that, consequently, the cash payments did not constitute a bonus. In holding that the provision for paying a portion of the operator's net profits did not make the transaction one where the taxpayer would receive income from the production and sale of oil, the Court stated (pp. 375–376):

> In this view, neither the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty, or a "bonus" in the nature of an advance royalty, within the decisions recognizing a right to the depletion allowance with respect to payments of that sort. * * * The words "gross income from the property," as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves.

The *Elbe* case cannot be distinguished on the ground that there the transaction was in the form of a sale of the property, while here the parties entered into a leasing agreement. Cf. Pet. Br. 20–21. As previously pointed out (*supra*, pp. 9–10), it is the particular provisions for payment, not the form or the manner of transfer which is determinative. *Anderson* v. *Helvering*, 310 U. S. 404, 411. Accordingly, the *Elbe* case must stand for

the proposition that the reservation of the right to share in the operator's profits is not the retention of a depletable interest in the oil and gas deposits. If an interest in net profits were a royalty interest, or analogous to one,[3] the cash payments in the *Elbe* case would have been regarded as a true bonus or advance royalties, and depletable. See *supra*, p. 12, and *infra*, pp. 23–24. But, it was for the precise reason that the provision for sharing in the operator's profits did not give the taxpayer any interest in the production of the oil, and therefore, did not represent a depletable interest in the underlying oil, that the cash payments received in the *Elbe* case could not constitute advance royalties. Obviously, the money received could not be regarded as advance payment for future production when the taxpayer would never become entitled to any future production.

Similarly, in *Helvering* v. *O'Donnell,* 303 U. S. 370, the taxpayer was the owner of one-third of the stock of a corporation which possessed certain oil and gas properties. He sold the stock to another corporation which agreed to acquire the oil property and to pay to the taxpayer one-third of its net profits from development and operations. It was held that the taxpayer was not entitled to deduct an allowance for depletion on the portion of the net profits which he received since he had no capital investment in the oil and gas in place.

[3] That such an interest is not a royalty interest is evident from *Anderson* v. *Helvering*, 310 U. S. 404, 409.

No material distinction can be made because, prior to the transaction, the taxpayer in the *O'Donnell* case had no economic interest in the oil and gas in place, he being only a stockholder in the corporation which owned the property. Cf. Pet. Br. 19–20. Plainly, if the taxpayer there had acquired a true royalty interest, instead of a share of operating profits, his right to share in gross production would have given him a proportionate depletable interest. The decision actually demonstrates that since the transferee was entitled to all the gross production, it possessed the entire depletable capital investment; since the taxpayer's right to participate in net profits did not entitle it to share in production as it took place, he could not have an interest in the oil deposits which would become exhausted as extraction occurred. In this respect, the Court stated (pp. 371–372):

> When the Midway Company acquired these properties from the San Gabriel Company and operated them, *the Midway Company became the owner of the oil and gas produced. It was the owner of the gross proceeds or income upon which the statutory allowance for depletion was to be computed. Helvering* v. *Twin Bell Syndicate, supra.* The agreement to pay respondent one-third of the net profits derived from the development and operation of the properties was a personal covenant and did not purport to grant respondent an interest in the properties themselves. If there were no net

profits, nothing would be payable to him. No trust was declared by which respondent could claim an equitable interest in the *res*. As consideration for the sale of his stock in the San Gabriel Company respondent bargained for and obtained an economic advantage from the Midway Company's operations but that advantage or profit did not constitute a depletable interest in the oil and gas in place. [Italics supplied.]

The *O'Donnell* and *Elbe* cases, *supra*, were summarized in *Anderson* v. *Helvering*, *supra*, as follows (p. 409):

> A share in the net profits derived from development and operation, on the contrary, does not entitle the holder of such interest to a depletion allowance even though continued production is essential to the realization of such profits.

The requisite interest in production which gives rise to a depletable interest, as distinguished from a mere economic advantage derived from production which does not evidence a capital investment in the underlying minerals, is also illustrated by *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362. It was there held that a processor of casinghead gas who was entitled to receive the gas as it was produced, but who could not compel its production, did not have any interest in the wet gas in place and was not entitled to claim a deduction for depletion. The *Bankline* case thus follows the constant pattern of the decisions that a depletable interest in the underlying minerals can

only be attributed to the persons who have such a direct economic interest in gross production that the gross income derived therefrom may be said to result from the severance and sale of their oil.

Treasury Regulations 103, Appendix, *infra*, pp. 44–47, specifically exclude an interest in net profits from being a depletable interest, Section 19.23 (m)–1 providing:

> But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or *to share in the net income derived from the interest of such owner does not convey a depletable economic interest.* [Italics supplied.]

The basis for the decision of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner v. Crawford,* 148 F. 2d 776, petition for a writ of certiorari granted, No. 197, this Term (to be argued immediately after this case), holding that the interest in net profits there involved was a depletable interest, is not clear. It seems, however, that the Court failed to distinguish between a fee interest in the property and an economic interest in the oil and gas in place. Cf. *Anderson v. Helvering,* 310 U. S. 404.

The Tax Court, it would appear, regards an interest in the operator's net profits as being depletable only when it is accompanied by a royalty interest in gross production. Thus, in contrast to its decision in the present case and its decision in *Crawford* v. *Commissioner,* decided March 24, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,098), affirmed 148 F. 2d 776, petition for a writ of certiorari granted, No. 197, this Term, the Tax Court held, in *Estate of Japhet* v. *Commissioner,* 3 T. C. 86,[4] that the assignor of an oil and gas lease who received a lump sum payment and who was entitled to a share of the operator's net profits, did not retain a depletable interest. The Tax Court distinguished its decision in the present case, stating (p. 93):

> Our recent decision in *Kirby Petroleum Co.,* 2 T. C. 1258, is distinguishable. In that case the taxpayer in its assignment of

[4] Compare, however, *Felix Oil Co.* v. *Commissioner,* decided December 18, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,662), affirmed, 144 F. 2d 276 (C. C. A. 9th). In so far as the *Felix* case appears to rest on the retention of a reversionary interest in the property, it is believed to be contrary to the principle that the provisions for payment, not the form of the conveyance or the local law respecting legal ownership, determine the existence of a depletable interest. *Supra,* pp. 9-10. Where the lessor retains a reversionary interest in the title to all the oil in place which will become operative upon forfeiture or termination of the lease, moreover, it seems fairly plain that a present depletable interest does not exist in the lessor merely because he may become repossessed of his complete capital investment at some future time.

> the lease reserved to itself a one-sixth oil royalty, thus reserving to itself an interest in the oil in place.

Also, in *Crawford* v. *Commissioner, supra,* the Tax Court concluded that the right to share in net profits was a depletable interest because the lessor "retained an economic interest in the oil by virtue of the royalty interest retained in each of the leases."

We submit that it is altogether untenable to hold that an interest in the operator's net profits may or may not represent a depletable interest, depending upon whether the right to receive royalties has been retained. A royalty, representing the right to share in the production of the oil, clearly gives rise to gross income from the sale of oil and is depletable. But how that interest becomes enlarged to include a more extensive one in the production of oil merely because there is an additional right to share in net profits, or how the share of net profits represents a share of the production of oil *only* when there is another and different right to a portion of production through oil royalties, is exceedingly difficult to comprehend.

We submit that there is no reason why a share in the operator's net earnings should give rise to a depletable interest in the oil produced; but if such a reason does exist, the net profits should not be chameleonic, their character changing with the

other interests which the assignor or lessor may possess.[5]

In this respect, there is so decided a difference between a cash bonus payment and an interest in net profits, that it cannot be argued that the latter, like the former, is depletable when accompanied by a royalty interest, but that it is not

[5] We believe that the unsoundness of the Tax Court's position in cases of this sort must be evident from a consideration of the incongruity that would result if its rulings were applied to a situation where the taxpayer does not retain a royalty interest at the time of the operating agreement, but acquires one later. For example, if there had been an outstanding royalty interest in the *Japhet* case which was owned by a third party and if the taxpayer in that case had received a cash payment and the right to share in the operator's net profits, the operator undertaking to pay the one-eighth royalty to the owner of the outstanding mineral interest, the Tax Court ought to hold that the taxpayer could not take depletion on the net profits received. Thus, the operator would receive seven-eighths of the depletion allowance and the owner of the royalty interest would be entitled to one-eighth of the deduction. If, later, the taxpayer should acquire the outstanding royalty interest, would the taxpayer then be entitled to take depletion on the net profits received as well as on the royalty interest? The reasoning of the Tax Court in the present case and in the *Crawford* case, *supra*, would apply equally well to that situation. Yet, we submit, it is fairly obvious that the operator's right to depletion should not be diminished by a transaction in which he would have no interest and to which he would not be a party. We believe that the taxpayer in that situation ought not to be entitled to depletion on the net profit payments and we believe, with equal force, that there are no reasons why the taxpayer here should be entitled to the deduction with respect to the net profit payments. Cf. *Badger Oil Co.* v. *Commissioner*, 118 F. 2d 791 (C. C. A. 5th), certiorari denied, 314 U. S. 634.

depletable when no royalties have been retained. Where the owner of oil producing property transfers all his interest in the underlying oil for a cash consideration and "severs his connection with the production of oil and gas and the income derived from production," the money received constitutes the proceeds derived from the sale of a capital asset. *Anderson* v. *Helvering,* 310 U. S. 404, 408. If he also retains an oil payment, he is regarded as having sold all of his interest in a portion of the oil in place and as having retained an interest in so much as will satisfy the payments due him. He is entitled to depletion only on the oil payments (*Thomas* v. *Perkins,* 301 U. S. 655); the cash is regarded as proceeds from the interest sold and no part of it is treated as a depletable bonus (*Commissioner* v. *Fleming,* 82 F. 2d 324 (C. C. A. 5th); *Cullen* v. *Commissioner,* 118 F. 2d 651 (C. C. A. 5th); *Hammonds* v. *Commissioner,* 106 F. 2d 420 (C. C. A. 10th); *Commissioner* v. *Roeser & Pendleton,* 118 F. 2d 462 (C. C. A. 5th), certiorari denied, 314 U. S. 635; *Columbia Oil & Gas Co.* v. *Commissioner,* 118 F. 2d 459 (C. C. A. 5th)).

Where, however, the owner retains a fractional interest in production through an oil royalty and invests his transferee with a partial interest in the oil to be produced, a cash bonus received by the owner does not represent the proceeds from the sale of a capital asset. *Burnet* v. *Harmel,* 287 U. S. 103; *Cullen* v. *Commissioner, supra.* The reasoning underlying this result is important.

Because of his royalty interest, the lessor has continuing rights in the extraction and sale of all of the underlying oil; his interest extends to a fractional portion of every barrel of the oil in place; under such circumstances, the bonus can no more be regarded as the proceeds from the sale of a capital asset than the royalties themselves, which are considered as ordinary income. *Burnet* v. *Harmel, supra.* In this manner, the bonus is regarded as "payment in advance for oil and gas to be extracted," and, since it represents "gross income from the property," it constitutes a depletable interest. *Herring* v. *Commissioner,* 293 U. S. 322, 324. Thus, whether the cash payment is a return of capital, or ordinary gross income from the property, depends upon whether the recipient retains a continuing interest in production. Only when the cash payment constitutes gross income from the production and sale of oil does it represent a depletable interest.

This reasoning has no application to an interest in net profits. Even where a royalty interest is retained, a share in net profits payable over the term of the lease does not constitute a depletable interest because although, like a bonus, it constitutes ordinary income to the recipient, unlike the bonus, it does not constitute "gross income from oil and gas" (*Helvering* v. *Twin Bell Syndicate,* 293 U. S. at p. 321), and it certainly cannot be considered as "payment in advance for oil and gas to be extracted" (*Herring* v. *Commissioner,*

293 U. S. at p. 324). The payments are not in anticipation of extraction but are to be made only if the lessee is able to earn profits. Moreover, the treatment of a bonus as an advance royalty has been expressly incorporated in the applicable Treasury Regulations ever since 1918. *Douglas* v. *Commissioner,* 322 U. S. 275. An interest in net profits payable over the term of the lease has never been considered depletable; the regulations applicable here expressly provide to the contrary.[6]

Petitioner suggests (Br. 15–16) that the Commissioner was pursuing an inconsistent position in refusing to grant the taxpayer the allowance for depletion with respect to the net profit payments received and, at the same time, in taxing the payments to it as ordinary income.[7] Actually, no inconsistency exists whatsoever.

So far as the lessor is concerned, the net profit payments received have all the attributes of

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[6] See *supra*, p. 19. *Spalding* v. *United States*, 97 F. 2d 697 (C. C. A. 9th), certiorari denied, 305 U. S. 644, relied on by the taxpayer (Br. 21–22), did not involve a sharing of the operator's profits.

[7] Judge Hutcheson stated in his dissenting opinion (R. 48):

"The commissioner does not contend that the 20 percent payments are taxable as ordinary income to the lessees and not to the taxpayer, as was successfully contended in some of the cases commissioner cites, and as would be the case here if the commissioner is right. Quite to the contrary, he accepts them as ordinary income as they were returned by Kirby, and insists on taxing them as such. As *Anderson* v. *Helvering* makes clear, if Kirby is not entitled to depletion on these payments, it is because they are the income of the operators and taxable to them."

ordinary income. Cf. *Schermerhorn Oil Corp. v. Commissioner,* 46 B. T. A. 151. This is true even if, from the standpoint of the lessee, the payments are regarded, not as a deductible business expense, but as a consideration for the lease, for it is not at all incongruous to view the net profit payments as "consideration for the lease *and* * * * income of the lessor." *Burnet* v. *Harmel,* 287 U. S. 103, 112. [Italics supplied]. "Not infrequently, payments made for an article constitute a capital investment by the payor, but income to the recipient." *Sunray Oil Co.* v. *Commissioner,* 147 F. 2d 962, 966 (C. C. A. 10th), certiorari denied, May 21, 1945. Because of its continuing interest in production by way of oil royalties, the lessor has not made a sale of any capital assets. Instead, in addition to its retained interest in production, the lessor has contracted for and has received an economic advantage resulting from the operator's ability to earn profits. That contractual right results in the receipt of taxable income even though it does not constitute gross income from the property. It is no more gross income from the property than would have been the case if the lessees had promised to pay a stipulated portion of the profits from their entire business and not merely from the operation of these particular oil properties. Thus, the receipt of a share of the net profits is analogous to the receipt of "delay rentals" which, although ordinary income to the lessor, are not income from the

proceeds of oil and gas and, hence, are not subject to depletion. *Houston Farms Development Co.* v. *United States,* 131 F. 2d 577, rehearing denied, 132 F. 2d 861 (C. C. A. 5th); *Commissioner* v. *Wilson,* 76 F. 2d 766 (C. C. A. 5th).

So far as the lessees are concerned, the income from the oil produced from the property, except for the advance and present royalty interests retained by the lessor, is gross income to them includible in their taxable income in full and with respect to which they are entitled to percentage depletion. The net profit payments are not to be excluded from their gross income in computing depletion under Section 114 (b) (3) as "rents or royalties paid or incurred by the taxpayer in respect of the property." *Burton-Sutton Oil Co.* v. *Commissioner,* 150 F. 2d 621 (C. C. A. 5th), petition for a writ of certiorari filed, No. 361, this Term; Section 19.23 (m)-1 (f) of Treasury Regulations 103 (Appendix, *infra,* pp. 45-46). See also, *Quintana Petroleum Co.* v. *Commissioner,* 143 F. 2d 588 (C. C. A. 5th). This exclusion clause, which was first incorporated in Section 114 (b) (3) of the Revenue Act of 1932, c. 209, 47 Stat. 169, was merely declaratory of the proper construction of Section 114 (b) (3) of the Revenue Act of 1928, c. 852, 45 Stat. 791, and corresponding provisions of the Revenue Act of 1926, c. 27, 44 Stat. 9 (Section 214 (a) (9)), which provided merely for the allowance of percentage depletion based on "gross

income from the property" without a specific exclusion clause (see *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312; H. Rep. No. 1492, 72d Cong., 1st Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 539, 542)), and the amount to be excluded from the lessee's gross income from the property now, as before the amendment, is an amount which will represent the lessor's gross income from the property.[8] See *Helvering* v. *Twin Bell Syndicate, supra; Thomas* v. *Perkins,* 301 U. S. 655. The word "rent" in this clause is used synonymously with royalties to denote a share of production. This Court has used the term "rents or royalties" to describe the payments made for the privilege of extracting iron ore (*Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, 522) and in some jurisdictions an oil royalty interest is described as a "rent" and gives rise to the same legal consequences (*Elsinore Oil Co.* v. *Signal Oil Etc. Co.,* 3 Cal. App. 2d 570; *Miller* v. *Carr,* 137 Fla. 114; *Mc-*

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[8] While the taxpayer asserts (Br. 16) that the net profit payments were "* * * not even included by the respondent in the taxable income of the lessee" and "* * * the respondent did not class it [the net profit payments] as taxable income of the lessee," we are informed by the Bureau of Internal Revenue that the lessees reported in their gross taxable income the full amount received from the sale of five-sixths of the oil produced, and that there was no exclusion on account of the net profits payments made. Likewise, the lessees claimed, and were allowed, a deduction for depletion calculated on the gross income from five-sixths of the oil produced and sold, undiminished by the amount of their net profits paid to the taxpayer.

Intire's Administrator v. *Bond,* 227 Ky. 607; *Crain* v. *West,* 191 Ky. 1; *Roberson* v. *Pioneer Gas Co.,* 173 La. 313; *Board of Com'rs of Caddo Levee Dist.* v. *Pure Oil Co.,* 167 La. 801; *United Gas Public Service Co.* v. *Barrett,* 179 So. 506 (La. App.); *Gray* v. *Commissioner,* 5 T. C. No. 33; cf. *Commissioner* v. *Wilson,* 76 F. 2d 766 (C. C. A. 5th)).

Even if the decisions of this Court were less clear in supporting the Commissioner's determination in this case, we believe that the unsoundness of the taxpayer's position would be evident from the peculiar and labored concepts which it must advance in support of its theory. That is, the taxpayer must assert that, in addition to its fractional royalty interest, an indefinite portion of each barrel of oil produced *may* represent oil in which it had a capital investment prior to severance, depending upon whether the lessees *happen* to earn profits. We believe that there is no warrant for concluding that a greater proportion of the taxpayer's oil lies near the surface and is extracted in the years when there are operational earnings, but that a greater proportion of the lessee's oil is produced and sold in the years when there are no profits. If such reasoning had any validity, it could as easily have been applied to conclude that the taxpayer in the *Elbe* case had retained, and that the taxpayer in the *O'Donnell* case had acquired, an interest in the oil in place which was depleted in the years that there were

net profits, and that the extent of that interest depended on the amount of the net profits earned.

If, during the time that there may be no net profits, all the oil produced, over and above that represented by the lessor's interest in gross production, belongs to and is attributable to the lessee, it seems plain that the same proportion of the oil produced remains the lessee's oil during the time that there are net profits. A lessee cannot, by agreement, divest himself of the attributes of ownership and exclude from his taxable income the proceeds derived from the sale of oil which belongs to him. Cf. *Harrison* v. *Schaffner*, 312 U. S. 579; *Helvering* v. *Eubank*, 311 U. S. 122; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Clifford*, 309 U. S. 331; *Burnet* v. *Leininger*, 285 U. S. 136; *Lucas* v. *Earl*, 281 U. S. 111.

The theory which the taxpayer must advance, and which is partially expressed in the dissenting opinion in the Circuit Court of Appeals, becomes transparently untenable when pursued to its logical conclusions. Thus the taxpayer contends (Br. 22) that "The provision concerning net profits was merely a method of determining the part of the minerals or their proceeds that should be paid to the petitioner as the owner of the minerals in fee." Also, the dissenting opinion below considered the provision for dividing the net profits as only a shorthand way of stating that the "lessor retained, and was to have, 20 percent of the gross profits from production, subject,

however, to the payment of 20 percent of the specified expenses, * * *" (R. 46).[9] These statements are of attractive simplicity but lose all substance when critically examined for meaning.

If the parties truly intended that the taxpayer should have an additional right to gross production, then the "gross income" from the property which is attributable to the taxpayer, and with respect to which it is entitled to depletion, has been obviously distorted. The anomalies which ensue can best be illustrated by a simple example. Assume that there is a leasing agreement whereby the lessor reserves a one-eighth royalty interest and is entitled to 20 percent of the lessee's net profits, that the gross price of crude oil is $1.15 per barrel, and that the cost of production is 70 cents per barrel, with a net of 45 cents per barrel. If 300,000 barrels are produced, the total gross income from the property would be $345,000, of which the lessor would be entitled to $43,125 (or 37,500 barrels) on account of his royalty interest. The total net profits of the lessee, after deducting the royalties paid (as the agreement in this case provides), would be $91,875, of which $18,375

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[9] We do not understand that Judge Hutcheson suggests that the taxpayer was entitled (over and above its royalty interest) to 20 percent of gross production and was to be personally liable for 20 percent of the specified expenses. Under the agreement (R. 29–34), it is quite clear that the taxpayer would not be liable for any portion of the expenses during such time as there might be an operating deficit, and had no personal liability for any expenses at any time.

would be payable to the lessor. If the lessor's share actually represented, as the dissenting opinion suggests, 20 percent of gross production (remaining after the one-eighth royalty),[10] subject to the payment of specified expenses, then the lessor actually received 52,500 additional barrels of oil (⅕×(300,000 minus 37,500)) and the total production of its oil was 90,000 barrels (37,500 plus 52,500).

If 90,000 barrels of oil are attributable to the lessor, the remainder, or only 210,000 barrels, are attributable to the lessee. His gross income therefrom, on which depletion may be claimed and which must be reported as gross taxable income, is \$241,500 (210,000×\$1.15). On the taxpayer's theory, the lessor's total gross income from the property is \$61,500 (\$43,125 on account of the one-eighth royalty plus \$18,375 on account of its share of net profits). The total gross income on which both the lessor and lessee would take depletion and which, separately, would be reported as gross taxable income, is \$303,000 (\$241,500 plus \$61,500). This may be compared with the *actual* total gross income from the property of \$345,000. Thus, \$42,000 disappears altogether from the total gross income from the

[10] It is assumed that Judge Hutcheson intended to say that the taxpayer was entitled to 20 percent of the production remaining after it received its royalty oil. If he meant that the taxpayer had reserved 20 percent of all production without deducting its royalty interest, the example given above becomes more extreme.

property which must be reported for tax purposes and on which someone ought to receive percentage depletion.

This aberration plainly stems from the fallacious assumption that the lessor retained 20 percent of gross production subject to the payment of 20 percent of the expenses. And an attempt to avoid this disparity must lead to a true dilemma. One horn of the dilemma would lead to the conclusion that the lessor's interest is in the production of so many barrels of oil which, less expense of production, equals its share of the net profits payable. In the example given, the production of 40,833 barrels [11] is necessary to earn $18,375. The gross income from 40,833 barrels would be $46,958, and the lessor, if the theory is correct, ought to be entitled (in addition to its royalty interest) to depletion on this amount, and not on only $18,375, the amount of net profits received. Also, $46,958 is the amount which the lessor would be required to include in its gross taxable income, from which it would only be entitled to claim appropriate deductions in computing its taxable net income. If the lessor's interest in net profits truly represents an interest in gross production less expenses, the net profits received cannot represent gross profits. The lessor could not automatically claim a deduction for all items which, under the

[11] This, of course, does not equal one-fifth of the lessee's gross production, less royalties paid, which is actually 52,500 barrels.

contract, entered into the computation of "net profits", since all of these might not be deductible for tax purposes; the lessor certainly could not short circuit matters by failing to claim appropriate deductions and by reporting what it considered its net income as though it were gross income.[12]

The taxpayer, apparently, recognized the absurdity of this and did not claim depletion on the full gross proceeds calculated in this manner, nor did it report the full gross income which would be attributable to it under this theory. It must have also realized that if this theory were applied in this manner, the percentage of the oil which would be attributable to it would have no relation to the percentage of net profits payable. See *supra*, note 11.

The theory actually adopted by the taxpayer and the dissenting judge, however, follows the other horn of the dilemma. Basic to this theory is the assumption that, although the taxpayer was entitled to an additional 52,500 barrels of oil over its royalty interest, its gross income therefrom was only the portion of the net profits which it received, it being assumed that *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376, was applicable. Pet. Br. 12–15, 24–25. That case, however, is distinguishable in all respects and

[12] Some of the expenses deducted in computing net profits under the agreement (R. 31–32) might constitute nondeductible capital expenditures.

can have no possible application here. The *actual* price at which the oil was sold, it was held in the *Mountain Producers* case, constituted the gross income from the property on which depletion was to be taken; the fact that the selling price was not based on market price and that the purchaser undertook to pay the cost of production did not alter or add to the gross amount for which the oil was sold. In the present case, however, it is altogether clear that, if 52,500 barrels constitute oil in which the lessor has an interest, the gross selling price is the actual proceeds, if sold to third parties, or the current price, if purchased by the lessees, undiminished by any costs.[13] This, too, is the gross income, as defined by Section 19.23 (m)-1 (f) of Treasury Regulations 103 (Appendix, *infra*,

[13] In this respect, the agreement provides (R. 32-33):

"First Party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, and in which the parties hereto may be interested. Upon the sale of any of such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales. If it desires to do so, First Party may take over all or any part of such production itself for its own use and benefit, and in such event, the accounts (covering the lease referred to above) shall be credited on the following basis, to-wit:

"(a) On Oil: The current price per barrel on the date of respective runs to pipe line, or if not run to pipe line, then on date of respective runs to storage for account of First Party, posted by First Party for the field where the production is located.

"(b) For gas of any kind: The market value at the well.

"(c) Other Minerals: The market value at the well or mine."

pp. 45–46) which provides that "gross income from the property" shall be "the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well." Accordingly, *Helvering* v. *Mountain Producers Corp., supra,* has no application to the facts of this case, and the actual result which the view of the taxpayer and the minority below would achieve cannot possibly be in harmony with the theory advanced in support of it. That the *Mountain Producers* case has been misconceived is evident from the assertion (Pet. Br. 15) that the taxpayer in that case received "net profits". Actually, however, the taxpayer in the *Mountain Producers* case was entitled to a specified sum for each and every barrel produced; no production could take place in which the taxpayer in that case did not have a monetary interest, and that would be true even when there might be no profits from operations, *i. e.,* if production expenses exceeded the selling price. Thus the taxpayer in that case, unlike a party who receives a portion of net profits, had a partial but continuing interest in the production of oil which represented a depletable interest, and the only issue was how that interest should be measured.

Returning to results rather than theory, it is submitted that to grant the depletion allowance with respect to an interest in net profits is to ignore the physical realities of the situation. The Commissioner's position, on the other hand, is in

accord with actual economic factors. One cannot overlook the fact that physical depletion of the oil deposits takes place to the exact extent that there is gross production. Permitting the depletion allowance to be shared by the parties in the same proportion as they are entitled to participate in gross production, which the Commissioner contends is the only proper manner, obviously conforms to the manner in which physical depletion occurs as the oil is extracted. There is, however, no constant relation between production which results in depletion and the earning of profits. Severance of the oil may continue without the operator being able to show any earnings, or there may be relatively heavy production with only a small amount of profits. The granting of the depletion deduction to a lessor in accordance with his right to share in the lessee's net profits would change the fundamental nature of the allowance and would make it depend upon matters that have no bearing on the amount of physical depletion that occurs.

Applying the principles enunciated by this Court to the case at bar, it is clear that prior to the execution of the lease and the agreement, the taxpayer, as the fee owner, had the entire capital investment and depletable interest in the underlying oil and gas, with the exception of the one-eighth mineral interest outstanding in one tract of land. After the execution of the lease and

agreement, the taxpayer retained a direct interest in the oil produced to the extent that an oil royalty, or a share of gross production, was reserved to it. Consequently, the taxpayer retained its capital investment in a proportionate amount of the oil in place. As production occurred, the taxpayer received a partial return of capital and, in recognition of that, the statute permitted a deduction for percentage depletion on the gross income from that productoin. Likewise, to the extent that the taxpayer received advance royalties in the form of a cash bonus, advance depletion was allowed and an interest was retained in a proportionate amount of the oil and gas deposits which suffered physical depletion as the minerals were extracted. The owner of the outstanding mineral interest in one tract, of course, had a depletable interest in a corresponding amount of the oil and gas in place there. The lessees, however, acquired a direct interest in all the remaining production of the oil and gas. Aside from the aliquot share of gross production which was attributable to the taxpayer's retained interest (represented by the advance and present royalties) and to the owner of the outstanding mineral interest, the remainder of the oil produced was attributable to the lessees' interest and, as production took place, that interest became proportionately depleted. The lessees were entitled, therefore, to percentage depletion on the gross proceeds derived from the production

and sale of all the remaining oil. Their right to the deduction could not be partially defeated by the taxpayer's claim to depletion on the share of the lessees' net profits to which it was entitled.

The single deduction for depletion being allotted to the parties in that proportion, it plainly follows that the lessor was not entitled to any additional deduction with respect to the share of the lessees' net profits which was payable to it. Since the lessees' net profits bear no direct relationship to the amount of oil produced, and since production and physical depletion of the deposits may occur without there being any net profits, the lessor, having no assurance of a share upon production in this respect, does not have an interest in the oil in place for which the depletion allowance is granted.

II

THE DECISION OF THE TAX COURT WAS "NOT IN ACCORDANCE WITH LAW" AND WAS PROPERLY REVERSED BY THE CIRCUIT COURT OF APPEALS

The Tax Court adopted as its findings of fact (R. 11) a stipulation which had been agreed on by the parties (R. 22–36). The Circuit Court of Appeals reached its decision on the basis of those facts. While, as the taxpayer correctly states (Br. 10), the Tax Court considered the lease (R. 24–28) and the contemporaneous agreement granting participation in the operators' earnings (R. 29–34), as though they were one transaction

for tax purposes, there is no warrant for the complaint made in the petition for a writ of certiorari that the court below disregarded this and treated the transactions as separate (Pet. 4, 5, 14–15). The Circuit Court of Appeals did not even intimate that its decision was based upon the fact that two separate documents were signed or that it would have reached a different result if the agreement had been embodied in the lease. Both the Tax Court and the Circuit Court of Appeals arrived at their respective conclusions without attaching the least bit of significance to this fact, and the taxpayer, apparently, has now abandoned its contention to the contrary (Br. 4).

The Circuit Court of Appeals did not differ with the Tax Court on what the facts were, or on what proper factual inferences should be drawn; it did differ with the Tax Court respecting the proper interpretation of the phrase "gross income from the property" in Section 114 (b) (3) of the Internal Revenue Code (Appendix, *infra*, p. 44). Cf. Pet. Br. 7–12. As we have shown, that phrase has acquired a very definite meaning through a long-continued construction by this Court and repeated Congressional enactment. If, as we contend, the decision of the Tax Court rests on a departure from that meaning, the decision is "not in accordance with law" and was properly reversed on review. Section 1141 (c) (1) of the Internal Revenue Code; *Trust u/w of Bingham* v.

Commissioner, decided by this Court on June 4, 1945; *Security Mills Co.* v. *Commissioner*, 321 U. S. 281; *Dixie Pine Co.* v. *Commissioner*, 320 U. S. 516; *Helvering* v. *Amer. Dental Co.*, 318 U. S. 322. Also, in holding that an interest in net profits constitutes "gross income from the property" if it is accompanied by a royalty interest in gross production (see *supra*, pp. 20–21) the Tax Court is applying a rule of general applicability which is properly subject to correction by the reviewing court. *Trust u/w of Bingham* v. *Commissioner, supra*.

It must be apparent that the present case gives rise to an entirely different kind of question than that presented by cases where the crucial issue must be determined by examining imperceptible variations in factual matters that may be present in particular instances. In transactions looking to the exploitation and development of oil and gas deposits, each type of payment gives rise to the same economic consequences regardless of other variations which may be found in the agreements between the parties. As a result, the application of general rules to crystalized factual patterns in such cases does not necessitate that the same finality be accorded the determinations made by the Tax Court as is true in situations where it is necessary to evaluate subtle changes from case to case in arriving at a correct or permissible determination.

CONCLUSION

In view of the foregoing, the judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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Solicitor General.

Samuel O. Clark, Jr.,
Assistant Attorney General.

Sewall Key,
Helen R. Carloss,
Hilbert P. Zarky,
Special Assistants to the Attorney General.

October 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:

*   *   *   *   *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income bene-

ficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

(26 U. S. C. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 114.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (m)-1 [as amended by T. D. 5413, 1944 Cum. Bull. 124, 129]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of im-*

provements.—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

*   *   *   *   *

(f) * * *

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for

which the taxpayer sells the oil and gas in the immediate vicinity of the well. * * *

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to section 19.23 (m)–10 (e).

* * * * *

SEC. 19.23 (m)-4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross

income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see paragraphs (f) and (g) of section 19.23 (m)-1.) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

U. S. GOVERNMENT PRINTING OFFICE: 1940

IN THE

Supreme Court of the United States

October Term, 1945.

No. 56

KIRBY PETROLEUM COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

MOTION FOR LEAVE TO FILE AMICI CURIAE BRIEF AND BRIEF OF AMICI CURIAE.

CULLEN R. LISKOW,
NORMAN F. ANDERSON,
ELIAS R. KAUFMAN,
W. W. THOMPSON,
Amici Curiae.

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IN THE

SUPREME COURT OF THE UNITED STATES.

October Term, 1945.

No. 56.

KIRBY PETROLEUM COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

MOTION FOR LEAVE TO FILE AMICI CURIAE BRIEF.

TO THE HONORABLE COURT:

Cullen R. Liskow, attorney at law residing at Lake Charles, Louisiana, and duly admitted to practice before this Court, respectfully petitions the Court for leave to file, in the above entitled cause, *amici curiae* brief.

In support thereof, he says that he, with Norman F. Anderson, Elias R. Kaufman, W. W. Thompson, also attorneys at law residing at Lake Charles, Louisiana, is attorney for the petitioner in *Burton-Sutton Oil Company,*

Incorporated vs. Commissioner of Internal Revenue, Docket No. 361 of the present term of this Court which is now pending on application for certiorari to review a decision of the United States Circuit Court of Appeals for the Fifth Circuit. The issue in that case is the exclusion from gross income of net profits payments made by the petitioner to its transferor. The same basic principal is involved in the above entitled cause and also in *Commissioner of Internal Revenue vs. Anna Vickers Crawford*, No. 197, of the present term, where the specific issue is the allowance of depletion in respect of net profits payments. The Government agrees that the ultimate decision in the *Kirby* case may be decisive of the exclusion issue in docket No. 361.

Copies of this motion, together with the brief, have been handed to the attorneys for petitioner and respondent, and their written consent for the filing of the accompanying brief is attached hereto.

Respectfully submitted,

.............................,

CULLEN R. LISKOW,
Weber Building,
Lake Charles, Louisiana.

Of Counsel:

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NORMAN F. ANDERSON,

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ELIAS R. KAUFMAN,

.............................,

W. W. THOMPSON.

IN THE

SUPREME COURT OF THE UNITED STATES.

October Term, 1945.

No. 56.

KIRBY PETROLEUM COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

CONSENT IS GRANTED FOR THE FILING OF THE ACCOMPANYING BRIEF OF AMICI CURIAE.

.............................,
HOMER L. BRUCE,
Attorney for Petitioner.

.............................,
HAROLD JUDSON,
Acting Solicitor General.

IN THE

SUPREME COURT OF THE UNITED STATES.

October Term, 1945.

No. 56.

KIRBY PETROLEUM COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

BRIEF OF AMICI CURIAE.

I.

THE OPINIONS OF THE COURTS BELOW.

The opinion of the Tax Court (R. 10) is reported in 2 T. C. 1258, and that of the Circuit Court of Appeals (R. 38) in 148 F. 2d 80.

II.

JURISDICTION.

Jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

The judgment of the Circuit Court of Appeals was entered March 5, 1945. (R. 50.)

III.

STATEMENT OF THE CASE.

In the interest of brevity, no statement of the case will be made as it has been fully covered in brief of petitioner and respondent.

IV.

QUESTION PRESENTED.

Whether a net profits payment to be made throughout the term of the lease constitutes an economic depletable interest in oil and gas in place.

V.

STATUTES INVOLVED.

The applicable provisions of the statutes involved are set forth in an appendix, *infra* p. 18.

VI.

SPECIFICATION OF ERROR.

The Circuit Court of Appeals erred in holding that petitioner was not entitled to the depletion allowance on the amount received by it under the provisions of its contract that it was to receive 20% of the net profits arising

from the operation of oil and gas wells located on its property.

ARGUMENT.

Summary of Argument.

Point A.

The tax consequences to be given to oil net profits payments which are to be paid throughout the term of a lease is before this Court as an original proposition.

Point B.

The lessor has an economic interest in the oil and gas in place to the extent that it is entitled to share the net profits of the lessee and is entitled to an allowance for depletion.

Point A.

In the ordinary pattern of provisions for net profits payments in oil and gas lease deals, the participation is from the moment of discovery until the complete exhaustion of the deposit, or throughout the term of the lease. Since the person entitled to such payments must depend solely upon the production for the recovery of his capital investment and continues to receive that return from all oil produced during the commercial life of the deposit, he is just as vitally interested in the mineral deposit as a

producer. Conversely, the producer derives no benefit from the net profit he is required to pay to his lessor. Thus it seemed logical that the respective parties should be taxed only upon their respective shares of income and that they should each be given an allowance for depletion in order to permit them to have a recovery of their respective capital investments when the mineral deposit was finally exhausted. It is significant that, prior to the year 1941, the Government recognized these tax consequences.

The new and the present position of the Commissioner is set out in G. C. M. 22730, 1941-1 C. B. 214, which clearly states that it rests solely upon the Treasury's analysis of this Court's decisions in *Helvering vs. O'Donnell*, 303 U. S. 370, *Helvering vs. Elbe Oil Land Development Co.*, 303 U. S. 372, and *Anderson vs. Helvering*, 310 U. S. 404.

The taxpayer in the *O'Donnell* case at no time owned any interest in the mineral deposit. He merely owned a part of the stock in a corporation which had oil properties and he sold his shares to a third person who agreed to acquire the corporation's oil properties and to pay for the shares, an amount equivalent to one third of the net profits that might be earned from operating the oil properties. The taxpayer there, as a stockholder, of course, had no investment in the oil and gas in place and it is obvious that no such investment was made by reason of a sale of corporate shares to one who was likewise without any capital investment in the mineral deposit. The taxpayer was denied depletion on the sums he received for the sale of his stock in the corporation but the result

would have been the same if the sale price had been measured by reference to gross production from the wells. This decision was so interpreted by the Court of Claims in *Haynes vs. U. S.*, 50 F. Supp. 238, where the stockholder was held entitled to treat the proceeds arising from the sale of his shares, which was measured by gross production of the oil properties, as from the sale of a capital asset. No application for certiorari was filed by the Government and the result is logical.

In the *Commissioner v. Elbe Oil Land Development Co.*, 303 U. S. 372, the taxpayer had owned the working interest but made an absolute sale for $2,000,000.00 plus the agreement of the purchaser to pay additional money in the amount of one third (1/3) of the net profits if, after the purchaser had reimbursed itself for the cost of acquisition and all subsequent development and operating costs and expenses, there were any profits. As this Court pointed out (page 374), the agreement there specifically provided:

> "It is the intention of the parties to this agreement that the full ownership, possession and control of all the properties * * * shall be vested in Honolulu (purchaser) and Elbe shall have no interest in or to the said properties * * *."

Accordingly, this Court held that after the execution of such a contract, the taxpayer had no further interest in the properties and was not entitled to an allowance for depletion upon the $2,000,000.00 on the theory that it represented a bonus.

This Court granted the Government's application for certiorari in the *Elbe* case because of an asserted conflict with the decision of the Fifth Circuit Court of Appeals in *Commissioner vs. Fleming,* 82 F. 2d 324 (see 303 U. S. 374). In that case, the taxpayer assigned leases for cash payments plus certain amounts to be payable out of a portion of the gross production from the wells and he was held entitled to depletion on the part of the income representing payments out of production but not on the cash payment. The question for decision in the *Elbe* case was not as to an allowance for depletion in respect of the so-called net profits payments there provided for, but was whether the provision for these payments, under that particular contract, supported the contention that the cash payments represented a bonus or advanced royalty. The result, therefore, would have been the same if the contract had involved fixed oil payments out of gross production.

Under the peculiar conditions of the contract there, in addition to making it plain that the assignor had no interest in the properties, the contract gave the assignor no immediate interest in the production from the wells. The taxpayer's interest in production was postponed until the remote time, if ever, when the producer's operations had given it a complete recovery of the $2,000,000.00 cost of acquisition and all other expenditures for development and operation. Whether that interest would ever actually accrue was highly speculative. These differences serve to distinguish that case from the ordinary net profits provisions where the payment is to be made throughout the term of the lease.

Anderson vs. Helvering, 310 U. S. 404, laid down the rule that an economic interest looks solely to production for the recovery of the capital. The question for decision there was whether a depletion allowance was to be made in respect of a fixed consideration to be paid out of either (1) a certain percentage of gross oil production, or (2) the assignee's sales of fee interests in land.

In view of the foregoing, it is believed that the Government's interpretation of these decisions is erroneous and that the question of the tax consequences to be given to oil net profits payments, which are to be paid throughout the term of a lease, is before this Court as an original proposition.

Point B.

The lessor has an economic interest in oil and gas in place to the extent that it is entitled to share the net profits of its lessee.

The distinction to be drawn is to be determined by the practical and economic consequences. *Lynch vs. Alworth-Stephens Co.*, 267 U. S. 365, 370, *Burnet vs. Harmel*, 287 U. S. 103, 111, *Palmer vs. Bender*, 287 U. S. 551, 557, *Thomas vs. Perkins*, 301 U. S. 655, 659, *Helvering vs. F. & R. Lazurus & Co.*, 308 U. S. 252, 255, *Helvering vs. Clifford*, 309 U. S. 331, 334. The practical results of net profits payments in oil and gas lease deals are perhaps best seen by consideration of the facts in the case of *Commissioner vs. Felix Oil Co.*, 144 F. 2d 776, where the Ninth Circuit Court of Appeals held that the taxpayer, a fee owner,

was entitled to an allowance for depletion in respect of a 50% share of its lessee's net profits arising from the extraction of oil. These payments were the sole benefit accruing to the lessor for permitting the lessee to produce oil from its land. If the court there had not allowed depletion, the taxpayer would have been left without any means of recovering its investment in the minerals, or it would have been required to account for the income as arising from the sale of the oil in place.

The tax consequences following income arising from the sale of natural resources in place and income arising out of the operation of natural resources are well settled. If the transaction constitutes a sale of the mineral in place, the taxpayer is not, of course, permitted to take depletion on the income received, but, by the same token, he may offset the amount received against his basis for the purpose of computing gain and may apply the capital gains provisions to the resulting profit depending, of course, upon the length of time that the property had been held by him. He may, likewise, become entitled to the limitation on surtax as provided in Section 105 I. R. C. in the event the transaction represents a sale of natural resources which he has discovered. On the other hand, if the transaction does not constitute an outright sale but represents a lease or other similar transaction by which the taxpayer retains an economic interest in the property, then the entire amount of the payment must be included in taxable income, but the taxpayer would then be entitled to depletion for recovery of his capital investment.

There seems to be no logical reason why a lessor, who is entitled to receive a share of the profits throughout the

term of the lease, should be required or permitted to treat the transaction as a sale of the natural resources in place. The theory underlying the allowance for depletion is that a gradual sale is made and the allowance represents the reduction in the reserve from which the product is taken. *U. S. v. Ludey,* 274 U. S. 295, 301. The capital gains provisions and limited surtax rates on sales of oil properties were not intended to cover lease deals which look to the working of the mineral deposit for income to be realized gradually over the life of the deposit, and according to the actual results obtained from operations. Thus, in *Burnet vs. Harmel,* 287 U. S. 103, 106, it was said:

> "It is an incident of every oil and gas lease, where production operations are carried on by the lessee, that the ownership of the oil and gas passes from the lessor to the lessee at some time and the lessor is compensated by the payments made by the lessee for the rights and privileges which he acquires under the lease. But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act. Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time consuming operation and the payments made by the lessee to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property.

> "Such operations with respect to a mine have been said to resemble a manufacturing business carried on

by the use of the soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content. *Stratton's Independence v. Howbert*, 231 U. S. 399, 414, 415, 58 L. Ed. 285, 291, 292, 34 S. Ct. 136; see *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 61 L. ed. 460, 470, 37 S. Ct. 201."

The lessor who looks to net profits payments for the recovery of his capital investment is just as vitally interested in the oil and gas in place as the lessee-producer. Cf. *Lynch vs. Alworth-Stephens Co.*, 267 U. S. 365, where this Court held that the lessee had a depletable interest notwithstanding that title to the ore stood in the lessor, and said, at page 370:

> "Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other; and the extent of it, with the consequent deduction to be made, in each case, is to be arrived at in the same way."

Risk of loss of the deposit also marks an economic interest in the oil and gas in place. In *Palmer vs. Bender*, 287 U. S. 551, this Court, in determining who held an economic interest as between parties who, at least in substance, were sublessor and sublessee, said, at page 558:

> "Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests.

The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deductions in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."

The oil and gas industry knows only three considerations running to landowners under leases, namely (1) delay rentals, (2) bonuses or advanced royalties, and (3) rents or royalties. Delay rentals are made for the purpose of securing additional time in which to utilize the land and are not for the actual privilege of producing minerals. A bonus is a sum of money paid by the lessee to the lessor in consideration for the execution of the lease as distinguished from the rent or royalty reserved by the lessor to be paid by the lessee throughout the term of the lease. Rents or royalties are marked by the fact that they are to be paid throughout the term of the lease.

The character of these payments is not affected by the manner in which they are to be paid. *Helvering vs. Twin Bell Oil Syndicate,* 293 U. S. 312, 321. This Court has held that it is not concerned with the motives which lead the taxpayer to be satisfied with the proceeds he receives. *Helvering vs. Mountain Producers Corporation,* 303 U. S. 376, 382.

The Government does not deny that the lessor's net profits interest is lessened as the process of production goes on, that risk of the loss or destruction of the mineral

deposit is *pro-tanto* with the lessor's net profits interest or that such transactions look solely to working the underlying minerals for income, but it characterizes such interests as being merely in the ability of the producer to earn net profits and to account and pay them over. If a net profits payment is an interest in the ability of the producer to make net profits, the interest of a lessor in a royalty payable in kind is similarly in the ability of the lessee to find and extract the minerals, and that has never been considered as a reason for denying an economic interest. The lessor's reliance upon the lessee to account and pay over cash has been held not to have extinguished the lessor's economic depletable interest. *Helvering vs. Twin Bell Oil Syndicate*, 293 U. S. 312.

The construction urged by the Government would, in effect, read into Section 114 (b)(3) I. R. C. additional words to correspond with the words added in italics:

> "In the case of oil and gas wells, the allowance for depletion under Section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties, *which are payable in kind or, if in cash, are measured by a fractional part of the gross proceeds from sales of oil and gas,* paid or incurred by the taxpayer in respect of the property."

The essential purpose of Section 23(m) is to equitably apportion the single depletion allowance between the lessor and the lessee, according to the peculiar conditions in each case. Rents or royalties are used in Section 114

(b)(3) in their ordinary and common sense. These provisions are in *pari materia. Helvering vs. Twin Bell Oil Syndicate*, 293 U. S. 312, 320.

Payments arising out of the extraction of the oil to be made by the lessee to the lessor throughout the term of the lease for the privilege of producing minerals are rents or royalties in the commonly accepted meaning of those terms. The statutory provisions of (1) computation of gains on sales of assets allowing immediate deduction of the entire cost or other basis, (2) preferential treatment of gains from sales of capital assets, and (3) limited tax rates on sales of discovered oil properties were not intended to embrace lease deals which look solely to the working of a mineral deposit for income to be realized gradually over the life of the deposit and according to the actual results obtained from the producing operations.

To the extent that a lessor shares the net profits arising from the extraction of the minerals, his interests are lessened as production takes place, he assumes the risk of loss or destruction of the deposit, and he has a corresponding economic interest in the minerals in place.

The amount taxable to the lessor in respect of a net profits payment is the sum received or accrued during the taxable year and percentage depletion is allowable on such gross income. *Helvering vs. Mountain Producers Corporation*, 303 U. S. 376 and *Spalding vs. U. S.*, 97 F. 2d 697.

Provisions for net profits payments have been utilized by landowners who desire to participate in the economic

gains actually realized from the production of their minerals and, also by small independent producers who have sought to overcome their comparative lack of capital by working properties blocked up by the major units of the oil industry. There is nothing to indicate that there were any administrative difficulties in the method recognized prior to 1941. It is believed that the Government's present position, if sustained, will certainly result in many undue tax hardships and tax preferences which, in turn, will hinder landowners and independent producers in their efforts to secure a participation in the actual gains derived from severance of minerals.

CONCLUSION.

It is respectfully submitted that the judgment of the Fifth Circuit Court of Appeals should be reversed and that of the Tax Court of the United States be affirmed.

Respectfully submitted,

CULLEN R. LISKOW,
NORMAN F. ANDERSON,
ELIAS R. KAUFMAN,
W. W. THOMPSON,
Amici Curiae.

APPENDIX.

Internal Revenue Code:

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

(26 U. S. C. 1940 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * *

(b) Basis for Depletion.—

* * * * * *

(3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under Section 23(m) shall be 27½ per cen-

tum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23(m) be less than it would be if computed without reference to this paragraph.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 114.)

3.

SUPREME COURT OF THE UNITED STATES.

Nos. 56 and 197.—October Term, 1945.

Kirby Petroleum Company, Petitioner, 56 *vs* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.
Commissioner of Internal Revenue, Petitioner, 197 *vs.* Anna Vickers Crawford.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[January 28, 1946.]

Mr. Justice Reed delivered the opinion of the Court.

The writ of certiorari in *Kirby Petroleum Co.* v. *Commissioner* brings here for review the judgment of the Circuit Court of Appeals for the Fifth Circuit, 148 F. 2d 80, reversing the decision of the Tax Court, 2 T. C. 1258, which had sustained the taxpayer's position. The narrow issue is the deductibility under Sections 23(m) and 114(b)(3)[1] of the Internal Revenue Code of the depletion allowance of 27½ per centum of gross income from the

[1] Internal Revenue Code:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

. . . .

"(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. . . . In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . ."

"Sec. 114. Basis for Depreciation and Depletion.

. . . .

"(b) *Basis for Depletion.*—

. . . .

"(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property . . . ."

property during the taxable year, permitted by those sections from the taxpayer's gross income for 1940 from certain oil leases.

The taxpayer owned the fee simple title to certain Texas lands, except for a minor mineral interest which is not here involved. It leased the lands to two companies for the production of oil, gas and other minerals for a cash bonus, a royalty in the usual form and an agreement, executed contemporaneously with the lease and as part consideration therefor, that the taxpayer should receive twenty per cent of the net money profits realized by the lessees from their operations under the lease.

The same narrow issue is in *Commissioner* v. *Crawford*. In this latter case, the taxpayer owned an interest in fee in certain real estate in California. She, together with her co-owners, entered into several leases for portions of the property for the production of oil, gas and other minerals. For an understanding of the issues here presented, it is unnecessary to analyze the leases further than to say that they were given in consideration of bonuses, royalties in the usual form and additional payments from the net profits of the operation.[2] The Commissioner assessed a deficiency because of the denial of a claimed depletion allowance for 1938, 1939 and 1940. The Tax Court supported the taxpayer's position. The Circuit Court of Appeals affirmed. 148 F. 2d 776.

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In both cases, the Commissioner concedes that the depletion allowance of Sections 23(m) and 114(b)(3) is applicable to the bonuses and royalties.[3] The statutory provisions are identical for all years. The 27½ per centum of Section 114(b)(3) was therefore properly deducted by the taxpayers from these bonuses and royalties. In each of these years there was also income to these taxpayers from the lease provisions for the lessors to share in the net profits from the oil extracted from the leased lands. The taxpayers claim the right to deduct the 27½ per cent depletion from these receipts also. These are the deductions which the Commissioner disallowed. On account of the conflicting decisions

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[2] The following clause of one lease will illustrate the type of arrangement which produced the additional payments:

"When, and as soon as the 'Income Credits' of said account shall exceed the 'Operating Charges' of the Lessee, the Lessor shall be entitled to a secondary and additional royalty, the amount thereof to be one-half of such difference between the 'Operating Charges' and 'Income Credits' of said account." The leases defined methods of computation.

[3] Burnet v. Harmel, 287 U. S. 103, 111; Palmer v. Bender, 287 U. S. 551, 557. See Anderson v. Helvering, 310 U. S. 404, 409.

of the Circuits in these cases on the point, certiorari was granted by us. — U. S. —; — U. S. —.

The present provisions for depletion allowances have been worked out so as to give the holder of an economic interest in the oil or other natural resource an allowance for depletion.[4] While there are income incidents to the utilization of natural resources, there is also an obvious exhaustion of the capital used to produce the income. In theory the aggregate sum allowed for depletion would equal the value of the natural resource at the time of its acquisition by the taxpayer, so that at the exhaustion of the resource the taxpayer would have recovered through depletion exactly his investment. The administrative difficulties in taxation of oil and gas production in view of the uncertainties of quantities and time of acquisition, that is at the purchase of the property or at the discovery of oil or gas, finally have brought Congress to the artibrary allowance of 27½ per cent now embodied in Section 114(b)(3).[5] Thus, the 27½ per cent is appropriated by the statute to the restoration of the taxpayer's capital and the rest of the proceeds of the natural asset becomes gross income. *Anderson* v. *Helvering*, 310 U. S. 404, 407-8. It follows from this theory that only a taxpayer with an economic interest in the asset, here the oil, is entitled to the depletion. *Palmer* v. *Bender*, 287 U. S. 551, 557; *Thomas* v. *Perkins*, 301 U. S. 655, 659. By this is meant only that under his contract he must look to the oil in place as the source of the return of his capital investment. The technical title to the oil in place is not important. Title in a case of a lease may depend upon the law of the state in which the deposit lies. *Burnet*

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[4] Treasury Regulation 103, Sec. 19.23(m)-1, as amended by T. D. 5413, 1944 Cum. Bull. 124, 129:

"Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest."

[5] For the background of the present provisions, see Helvering *v.* Twin Bell Oil Syndicate, 293 U. S. 312.

v. *Harmel*, 287 U. S. 103, 109-10. The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted. See *Anderson* v. *Helvering*, 310 U. S. 404, 407.

The taxpayers here involved were lessors. Under the leases and our previous decisions, these taxpayers had an economic interest, a capital investment, in so much of the extracted oil as was used by the lessee to pay to the taxpayers the royalties and bonuses. See note 3, *supra*. The taxpayer lessors were entitled to the depletion allowance on these royalties and bonuses whether they were paid to them in oil or cash, the proceeds of the oil. *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312, 321.

If the additional payment in these leases had been a portion of the gross receipts from the sale of the oil extracted by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. The lessors' economic interest in the oil is no less when their right is to share a net profit. As in *Thomas* v. *Perkins*, 301 U. S. 655, their only source of payment is from the net profit which the oil produces. In both situations the lessors' possibility of return depends upon oil extraction and ends with the exhaustion of the supply. Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil.[6]

The depletion allowance, in the aggregate, is always the same amount, 27½ per centum of the "gross income from the property."[7] "In the case of leases the deductions shall be equitably apportioned between the lessor and lessee." Section 23(m). An equitable apportionment is obtained by excluding from the lessee's gross income from oil or gas produced from the property, *Helvering* v. *Twin Bell Oil Syndicate*, *supra*, 321; "an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." Section 114(b)(3).[8] Such deductions become the

[6] While the reservation of royalties shows an economic interest in the oil necessary for the satisfaction of the royalties, such reservation would not show an economic interest in oil not necessary for the payment of the royalties. But see Estate of Jophet, 3 T. C. 86.

[7] Sec. 114(b)(3). The gross income refers only to oil and gas. Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 320-21; Anderson v. Helvering, 310 U. S. 404, 408.

[8] See Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 322.

gross income of the lessor. We think these taxpayers had an economic interest in the oil, sufficient to support depletion on the sums received as net profit.

If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessors by the lessees was the portion of "net income" paid under the leases, it would be clear that such payment of "net income" would taxwise be rent or royalty paid by the lessees for the privilege of extraction. Since Section 114(b)(3) would require the lessees to deduct this rent or royalty from their gross incomes from the sale of oil from the property before taking the lessees' depletion, a gross receipt from oil sold, equal to the amount of the "net income" paid to the taxpayer lessors, would not be subject to depletion, unless the taxpayer lessors are permitted to apply depletion to this payment. This would be contrary to the purpose of the depletion statute, which is to allow to the lessor and lessee together a depletion of 27½ per cent of the gross sale price of the oil. On the other hand if depletion on the "net income" payments is allowed to the lessors, the lessees are allowed depletion on the gross income from oil sales less the net income payment and the entire allowable depletion is allocated between the lessors and lessees.

Reference is made to a sentence in *Anderson* v. *Helvering*, 310 U. S. 404, 409, as indicating that this Court had determined that "net profit" payments were not subject to depletion. It reads as follows:

> "A share in the net profits derived from development and operation, on the contrary, does not entitle the holder of such interest to a depletion allowance even though continued production is essential to the realization of such profits."

The *Anderson* case involved the taxability to the oil operator of the gross proceeds of the oil, which his contract for the purchase of the oil property required him to turn over to the seller as a means of satisfying a deferred payment for the property. As the deferred payment also had to be satisfied out of any sale of the fee simple title to the land, we held ~~the operator liable as a~~ purchaser because the seller was not "entirely dependent" upon the oil production for his purchase price. This gave the operator the benefit of the applicable depletion. Page 413. Only the reservation of an interest in the fee differentiated the *Anderson* case from *Thomas* v. *Perkins*, 301 U. S. 655, where deferred payment

in oil or its proceeds, payable only from production, was held subject to depletion when paid to the assignors.

The part just quoted from the *Anderson* case occurs in setting out the series of cases dealing with depletion. No net income was involved in the *Anderson* case. The statement was supported by the citation of *Helvering* v. *O'Donnell*, 303 U. S. 370, and *Helvering* v. *Elbe Oil Land Development Co.*, 303 U. S. 372. In the *O'Donnell* case, the taxpayer, who received the "net income" from an oil operation was a stranger to the lease, who had contracted for a share of its net profits as consideration for his stock in a corporation which was the owner of the lease. "The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place . . . . As a mere owner of shares in the San Gabriel Company, respondent had no such interest." Page 371. In the *Elbe Oil Land* case, there was a specific provision that consideration other than the "net profit" payment should result in "full ownership" to the buyer. The transaction which included the clause for "net profit" was a sale of all the right, title and interest in the property, which consisted of tangible personalty and drilling permits, agreements, and leases. This Court said the additional payment of a share of net profits did not qualify "in any way the effect of the transaction as an absolute sale." Page 375. Thus the *Anderson* case correctly stated that a share in "net profits," disassociated from an economic interest, does not entitle the holder to a depletion allowance. The facts of each transaction must be appraised to determine whether the transferor has made an absolute sale or has retained an economic interest—a capital investment.

In our view, the "net profit" payments in these cases flow directly from the taxpayers' economic interest in the oil and partake of the quality of rent rather than of a sale price. Therefore, the capital investment of the lessors is reduced by the extraction of the oil and the lessors should have depletion.

No. 56 is reversed.
No. 197 is affirmed.

Mr. Justice Jackson took no part in the consideration or decision of these cases.

Mr. Justice Douglas dissents.